THE INSTITUTE OF CHARTERED ACCOUNTANTS OF NIGERIA
(Established by Act of Parliament No 15 of 1965)

GUIDELINES FOR MERGER OF SMALL AND MEDIUM-SIZED AUDIT FIRMS

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PREFACE

Established by the Act of Parliament No.15 of 1965, the Institute of Chartered Accountants of Nigeria (ICAN) is statutorily empowered to set standards and regulate the practice of Accountancy in Nigeria.

As a member of the International Federation of Accountants (IFAC), it is part of ICAN's responsibility to ensure that the Institute's policies and guidelines are in line with global best practices.

These guidelines are developed by the Institute in pursuance of its desire to improve on the operations and quality of services members render to the public.

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FOREWORD

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.

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:

(a) Effectiveness and efficiency of service delivery;
(b) Reliability of financial statements;
(c) Compliance with applicable laws and regulations;
(d) Improvement on the networking of members;
(e) Promotion of the Accountancy Profession and
(f) 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 Nigerian Standard on Quality Control (NSQC 1). Again, firms wishing to merge should also comply with sections 576 and 577 of Companies and Allied matters Act and Part XII of Investment and Securities Act.

1.0 DEMOGRAPHY OF AUDIT FIRMS IN NIGERIA.

The total number of Audit firms in Nigeria as at 27th May, 2011 is approximately 916 (Nine hundred and sixteen). This number is made up of the following categories of firms:

NUMBER OF PARTNER(S)	NUMBER OF FIRMS	%
ONE	655	71.5
TWO	187	20.4
THREE	42	4.6
FOUR	17	1.9
FIVE	6	0.6
SIX	7	0.8
THIRTEEN	1	0.1
EIGHTEEN	1	0.1
	916	**100**

Source: Membership Affairs Record

From the table above it is evident that sole proprietorship comprises the highest number of practising firms. The table shows that out of 916 practising firms, one partner firms are 655 (Six hundred and fifty five) which is 71% of all the practising firms. The reasons for the dominance of this type of business association include:

(a) Unwillingness of the sole partner to lose control.
(b) Inability to look beyond the environment.
(c) Lack of collaboration among chartered accountants
(d) Lack of specialization
(e) The desire to work independently and take all the profit.

From the practice 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. The Institute is encouraging firms to merge so as to ensure improvement in the capacity of firms to carry out high quality audit assignments.

2.0 CHARACTERISTICS OF BUSINESS MODELS.

2.1 Sole practitioner.

This is a model in which the firm is owned by an individual. He takes all the initiatives and runs the firm relying on his knowledge and skill. This model is prevalent in accounting profession and should be discouraged due to various

challenges confronting it. Notwithstanding, Sole proprietorship has the following advantages:

There is privacy

(a) Profit is entirely for the owner
(b) Decisions are often taken quickly
(c) Limited capital required to start the firm

However, it has the following disadvantages:

Lack of continuity after the death of the owner;

(a) Lack of adequate finance for expansion;
(b) Poor quality of work;
(c) Lack of specialization;
(d) Inability to obtain big engagement;
(e) Inability to train staff;
(f) Inadequate documentation of records;
(g) Lack of collaboration with other firms to improve quality of service;
(h) Inability to attend various training programmes for lack of time;
(i) Makes acquisition of expertise difficult; and
(j) Lack of succession plan

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.

2.2 Partnership

Partnership is the relationship 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. It is in line with these benefits that partnership through merger is being encouraged among audit firms.

2.2.1 Rules for determining existence of Partnership

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

(1) 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.

(2) The sharing of gross returns does not of itself create a partnership, whether the persons sharing such 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.

(3) The receipt by a person of a share of the profits of a business is prima facie evidence that he 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-

(a) The receipt by a person of a debt or other liquidated amount by instalments 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;

(b) 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;

(c) 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;

(d) 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

(e) 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.

2.3 Business Integration

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

(a) 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.

(b) 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. However, those who wish to adopt this model are strongly advised to have a written agreement for the modus operandi of the integration.

Examples of Strategic Alliance are :

(i) **Alliance through areas of specialization**. Such as Taxation, Receivership, Liquidation etc.

(ii) **Alliance through sharing of resources.** Such as Technical, Financial, and Human Resources etc

(iii) **Big firms co-opting small firms through the following:**

- Information sharing
- Coordinating and consulting
- Joint management

(c) Merger/Acquisition

Merger: A merger is viewed as the situation where two or more companies combine together to form a larger business entity.

Acquisition: This involves outright purchase of another company or purchase of controlling shares in another company

3.0 BUSINESS MERGER.

General Principles

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 allow the acquired firm to proclaim that the action is a merger of equals, even if it is technically an acquisition.

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.

3.1 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.

3.2 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.

3.3 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.
- 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.

4.0 PRE-MERGER DUE DILIGENCE

Due diligence on all the firms wishing to merge is an imperative exercise.

It covers the following areas:

(a) Operational due diligence
(b) Human Resource due diligence
(c) Legal due diligence
(d) Financial due diligence.

5.0 RECOMMENDATIONS TO COUNCIL

The Institute has vital roles to play in encouraging firms to merge due to its numerous advantages.

Consequently, we make the following recommendations to Council:

- Provide the framework in terms of policy guidelines to encourage the merger process;
- Provide the policy and procedure to guide the merging process and ensure that it is not cumbersome and elongated;
- Encourage firms to carry out pre-merger due diligence exercise;
- Create awareness of merger to the partners through free counselling;
- Create a forum for firms wishing to merge to register their intentions;
- Organising free post merger seminars for firms that merged;
- Give adequate publicity to firms that merged in the journals, newsletters, accountants' conference etc.

6.0 APPENDICES

Appendix 1: Partnership/merger checklist

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

31.	Agree as to whether work in progress of the firms is to be billed out prior to merger	
32.	Instruct solicitor to commence drafting merger agreement or Partner/shareholder agreements	
33.	Professional bodies to be advised on new entity and new registration	
34.	Develop merger plan and timetable	
35.	Firms should ensure that the merger/partnership complies with the relevant statutes	

Appendix 2: Categories of firms

Description	Number of Partner (s)
(i) Sole Practitioner	1
(ii) Small firm	2-4
(iii) Medium firm	5-9
(iv) Large firm	10 and above