

## **PRACTICE CONTINUATION ARRANGEMENT**

The Institute's ***By-Laws Section B220: Death or Incapacity of a Sole Practitioner*** requires a sole practitioner to ensure that he or she has entered into an arrangement to enable his/ her practice to continue with minimum disruption in the event of his/ her death or incapacity, in either of the following ways :-

(a) by entering into an agreement with another sole practitioner or with a member firm;

or

(b) by satisfying the Council that other adequate provision has been made

Unless appropriate arrangements have been made, the continuing incapacity or death of a sole practitioner will cause considerable difficulty and inconvenience to clients. Furthermore, the resultant interruption of services will diminish the value of the practice and may even lead to its disintegration.

It is therefore important for a sole practitioner, to protect both his or her own interests as well as the interests of the clients to enter into such arrangements with another member or firm as this will enable the practice to be carried on with a minimum of disruption in the event of incapacity or death.

In this regard, the Institute has decided to assist sole-practitioners in complying with the ***By-Law B220*** by way of providing a guideline in the preparation of a practice continuation arrangement.

This guideline is available on the Institute's website at [www.mia.org.my](http://www.mia.org.my) under Public Practice-Managing Your Practice. Please take note that to determine the value of your firm you are requested to seek an expert's advice and not just rely on the guideline.

**The continuity agreement is a legal document and it is important that you obtain legal advice to ensure the arrangement is properly drawn up, can be implemented quickly and contains appropriate termination clauses. The personal representatives and immediate family members should be made aware of the existence of the continuity agreement and the basis on which it operates.**

As part of the Institute's risk management process, **NO SAMPLE AGREEMENT** will be made available. Only broad guidelines as enclosed are available for members' reference.

## **THE IMPORTANCE OF A PRACTICE CONTINUATION ARRANGEMENT**

### **True Story of Mr. A**

The following is a true story of a practising member of the Malaysian Institute of Accountants (MIA), Mr. A who passed away without making a practice continuation arrangement.

Mr. A passed away at the age of forty-seven. Within days of his demise, the practice he has built up over 15 years started to disintegrate. His existing clients were "taken away" by his manager and the rest of his employees quickly found employment elsewhere.

Mr. A had a life insurance and some savings set-aside for his surviving spouse and two children (a son and a daughter). But, at the same time he also had a large outstanding mortgage on the house where he and his family is living and the family's future was by no means assured. The said practice, built over years of hard work and sacrifice could no longer generate adequate income; indeed, before long it became practically worthless. Years later, when Mr. A's son met the previous manager of his late father's practice (the manager subsequently became a practising auditor), the only consideration that the man undertakes for taking away all the clients was that, if Mr. A's son ever decides to become a practising member of the accounting profession, he is willing to be his sponsor.

### **True Story of Mr. B**

Contrast this with another case of Mr. B, who has the foresight early in his practice to enter into an agreement with another practitioner in his community. The agreement provides for an orderly transfer of Mr. B's clients to the other practitioner and for the disposition of the practice's assets on a pre-agreed valuation. As a result, Mr. B's clients suffered no significant break in their accounting and taxation services and his existing staffs was provided with some assurance of immediate future employment. Equally important, Mr. B's family was comforted by vital financial support and peace of mind when they needed them most.

### **Love Letter for the Estate**

It is no wonder that Sir Winston Churchill once mentioned that such arrangement (in his mind, he was referring to Will), in the form of a yellowish piece of paper stored in a corner of a drawer when baptised by tears of the widow and children will evolve into the most beautiful piece of love letter for the estate.

### **Fail To Plan Is Planning For Failure**

The difference between Mr. A and Mr. B is a matter of foresight and planning. Mr. B realises the important of planning for his possible death or disability. This foresight led Mr. B to arrange for the orderly disposition of the assets of his practice,

especially the valuable client base that he has built up over the years. As a result, when he died, his practice continuation agreement went into effect immediately, to the benefit of her clients, employees and family. He knew that only a quick transfer would prevent the value of his practice from being dissipated.

Failure to plan is too often the case. When you commence your practice, death, disability and estate duty (though abolished in mid 1980s) are usually the furthest thing from your mind. Yet, this is the time when your long-term personal obligations and responsibilities are the greatest. An accident or sickness could annihilate your practice overnight leaving your family at risk. Most practitioners fail to realise that their families will not be able to continue the practice or even understand the intricacies of disposing of it.

### **Protection and Preservation of Clients' and Employees' Interest**

In addition, you also have a professional responsibility to your clients, whose business interests and personal tax matters could be seriously disrupted if you suddenly become unavailable. In addition, your employees deserve consideration too. Only through such a continuation arrangement can you guarantee your client's uninterrupted services and your employees the likelihood of continued employment while preserving the value of your practice for the loved ones you leave behind.

### **Preparing A Practice Continuation Agreement**

As with your personal Will, preparing a practice continuation agreement takes time and care. First, you must assess the value of your practice and identify a successor; then you must enter into negotiations, which can be frustrating and time consuming as well as demanding. But, without such an agreement, you stand to lose everything that you have worked so hard to build. Aside from owing it to yourself to be your own best client, you owe it to your family to leave them some financial benefits (i.e. the value of your accounting practice), which in certain cases would possibly form one of the largest assets in your estate.

### **Simple Guide To Preparing A Practice Continuation Agreement**

The following is a simple guide to the successful conclusion of a practice continuation arrangement that can be pursued in Malaysia.

#### **Caveat**

**However, please take note that the continuity agreement is a legal document and it is important to obtain legal advice to ensure the arrangement is properly drawn up, can be implemented quickly and contains appropriate termination clauses. The personal representatives and immediate family members (they could be the same persons) should be made aware of the existence of the continuity agreement and the basis on which it operates.**

## **Guidelines for Continuation of Practice**

### 1. Type of practice continuation agreement in Malaysia.

Generally, there is only one recommended type of practice continuation agreement in Malaysia, namely a One-on-One Agreement.

This agreement is usually a buy/sell agreement written to cover death or permanent and total disability of the said practitioner.

### 2. Basic preparations to be considered

Determine what effect the business and personal objectives will have on the probable choice of successor (continuity nominee), the valuation of the said practice and the overall preparations for negotiation.

Conduct an assessment of the said firm's reputation, specialities, rates, efficiency, profitability, location and staff.

In addition, there are some significant control statistics that indicate the financial health of a practice that should be available at the time of the negotiations. Please refer to *Section 1* for details.

Review the firm's accrual and cash-basis financial statements for the past 5 years where available before beginning negotiations with the successor firm.

Understand the potential successor's practice. The evaluation questions and control statistics that are used to evaluate the said practice can also apply to that of the successor's.

Update the client files and prepare client information for review by the successor, such as in *Section 2*.

### 3. Assess the value of the said practice

To ensure that the worth of the firm and of its individual clients can be determined. This information is important to conduct meaningful negotiations on various aspects of the practice continuation agreement.

Cash flow, client retention and profitability all affect the valuation of the said practice. 2 basic financial statements that will generally be considered are the balance sheet and the income statement from operations.

To start the valuation:

Choose a valuation method and if possible consider using more than one to establish a range of values for negotiations. Experts advice should be sought where necessary.

Prepare a valuation of the assets of the said practice:

- Tangible assets (fixed assets, accounts receivable and work in process)
- Intangible assets.

(Please refer to *Section 3* for more details)

#### 4. Search for a successor

Consider the options:

- The practitioner's own circle of well-respected practitioners.
- People whom the practitioner see regularly at seminar or other professional meetings, e.g. in the Institute's CPE events.
- Those who may have been a part of the practitioner's own informal support group or expressed an interest in the said practice:-
  - Staff
  - Previous employers or colleagues
  - Larger firm
  - Referrals from lawyers or bankers
- Some considerations in the choice of a successor:
  - Professionalism
  - Integrity
  - Reputation
  - Ethical
  - Ability to buy the said practice without becoming financially burdened
  - Same practice, philosophies, audit procedures and policies on clients
  - Geographical location
  - Efficiency
  - Specialties or expertise (client characteristics)
  - Fee structures
  - Professional qualifications (Please refer to *Section 4*)
  - Personal qualifications (Please refer to *Section 4*)
  - Community and professional standing (Please refer to *Section 4*)

- Draw up a list of possible candidates and then reduce the list to the most likely prospects.
  - Approach the candidates and hold preliminary talks (avoid any rush decisions).
5. Begin formal negotiations
- Determine the subjects of negotiation
    - Definitions
    - List of Clients
    - Working Papers
    - Permanent and Current Files
    - Books and Financial Statements
    - Work in Process and Account Receivable
    - Equipment and Supplies
    - Existing Leases
    - Employee Records
    - Liabilities and Malpractice Insurance
    - Property and Casualty Insurance
    - Fees and Billing Information
    - Payment for the Practice
    - No competition Clause
    - Termination of Agreement
    - Arbitration
    - Notification
    - Carryover Expenses
    - Other (Please refer to *Section 5*)
      - Set limits on the range of negotiation and the willingness to compromise
      - Payment methods (Please refer to *Section 6*)
6. Implement the plan once negotiations are completed
- Contact lawyer(s) to obtain legal advice on the form and content of the continuity agreement
  - Discuss the plans with spouse and lawyer(s)
  - Finalize letters of instruction to spouse, clients, lawyer(s) and staff, to be delivered in the event of the practitioner's death or permanent incapacitation
  - Communicate in writing to all parties what their role in the transfer will be
  - Ensure that all copies of the agreement and relevant documents are secure and that the necessary parties know the location
7. Ensure Wills have been drafted to enable the continuity agreement to come into force when required especially for areas, which are not covered in the continuity agreement.

8. Set up a meeting with the successor to finalize the agreement and meet at least annually with the successor to discuss any changes that could affect the agreement.
9. For those in partnership, where each partner has their own specialization, the arrangement may either be made within the partnership agreement or by entering into an agreement with another external party.

### **Section 1**

#### SOME SIGNIFICANT CONTROL STATISTICS:

- Standard fees per total personnel
- Standard fees per partner
- Standard fees per professional staff
- Net fees per total personnel
- Net fees per partner
- Net fees per chargeable hour
- Average chargeable hours per total personnel
- Average chargeable hours per partner
- Average chargeable hours per professional staff
- Standard fees per chargeable hour per total personnel
- Standard fees per chargeable hour per partner
- Standard fees per chargeable hour per professional staff
- Net income per partner
- Net income per chargeable hour
- Salaries for professional staff per chargeable hour
- Salaries for total personnel per chargeable hour
- Direct expenses per chargeable hour
- Indirect expenses per chargeable hour
- Ratio of capital to net income
- Average collection period

**Section 2**

Client profiles should provide, in columnar schedule form, the following data:

1. Name and legal form of the individual or company and the names and legal status of Affiliated companies where applicable
2. Public or private status of the company
3. Client's business
4. Client's location
5. Names and ages of principals and their equity percentages
6. Company structure and vulnerability to loss of a key executive
7. Period of time as a client
8. How client was obtained
9. Type and frequency of services rendered
10. Function and number of employees needed to handle the account
11. Extent of client's computerization and programs available
12. Average fees paid in the past 3 to 5 years for regular and special services
13. Number of company and personal tax returns prepared for principals and others
14. Potential for a fee increase
15. Direct costs of servicing the client
16. Adequacy of client working papers and records
17. Method of setting fees
18. Unusual service problems
19. Problems with integration of staff and client
20. Any other desirable data in the individual case

With this information, it should be comparatively easy to develop statistics on your practice by industry, fee size, engagement type, profitability range, manpower requirements, specialized services and other factors.

### **Section 3**

## **HOW TO VALUE YOUR PRACTICE**

### ***A. Valuation of Tangible Assets***

#### Fixed Assets

Equipment and other tangible assets can either be negotiated as part of the practice continuation agreement or valued separately. Is advisable to keep valuation as simple as possible as haggling over minor assets that may hold no value for your successor could sabotage an agreement.

A formal real estate appraisal can be obtained to determine an equitable value if land and buildings are involved.

#### Accounts Receivable

When the practice remains intact after it is sold, accounts receivable are often purchased to maintain the appearance of continuity for clients. In this case, you need to guarantee the value of accounts receivable or use a discount factor based on past collection experience. Current clients may be discounted, say 10 to 15 percent for the cost of collection. The discount should be greater for doubtful accounts. In the even of death, the discount factor may be further increased.

Should the estate decided to retain its rights over the collection of the accounts receivable, it can employs the successor firm as a collection vehicle and pays that firm for its efforts.

In any case, to protect your estate, you may want to state in the agreement that the estate will collect no bill for less than its full value without prior approval.

#### Work In Process

Placing a value on any work in process can be difficult as it is normally difficult to be determined or identified. Thus, in most instances, the value is not computed or taken into considerations.

### ***B. Valuation of Intangible Assets***

The most critical and elusive element in the valuation of a practice is the value of each client. It is basically the client list that provides for the future income stream, but clients are an intangible asset.

You will have a better chance of getting the price you desired if the prospects for client retention are high. But if your client base is not secure, the value of your firm diminishes in the buyer's eyes.

## **Section 4**

### ***Professional qualifications***

- a. Recent peer or quality review
- b. Organizational and planning abilities
- c. Proper monitoring and control of engagements
- d. Technical proficiency
- e. Client satisfaction
- f. Ability to train and develop staff
- g. Ability to generate fees and knowledge of the value of the services performed
- h. Ability to bill and collect promptly
- i. Sense of professional responsibility

### ***Personal qualifications***

- a. The appearance and presentation of the firm and its personnel
- b. Leadership within the firm
- c. Evidence of oral and written communications skills
- d. Good relations with colleagues and clients
- e. Gradations of expertise within the firm
- f. Useful mixture of personalities within the firm
- g. Growth potential

### ***Community and professional standing***

- a. Community leadership of firm principals and staff
- b. New clients brought in through individual contacts
- c. Professional participation and leadership accomplishments

## **Section 5**

After placing a value on your practice and identify your successor, you are ready to begin negotiation and constructing the agreement. However, it is ***strongly recommended to seek legal advice when drawing up such continuity agreement.***

There are many elements in constructing a continuity agreement. Outlined below are the basic terms and conditions that may be included in the agreement.

### **a. Definitions**

The 2 basic definitions that tied to the agreement are permanent disability or incapability and death or retirement.

Permanently disable is a total disability caused by physical or mental ill health. This should be confirmed by the medical practitioner and proved that the practitioner is physically and/or mentally unfit, through illness, accident or

otherwise, effectively to manage his/her practice and in the said medical practitioner's opinion, is likely to be incapacitated for more than \_\_\_\_\_ days.

Retirement is the termination of practice on an immediate or phased basis.

These definitions must be included in the contract and must be addressed with care to allow an element of flexibility.

**b. List of Clients**

It should contain a list of clients, the value that is placed on the business of each one and the method to determine and assign these values. The list is included as an exhibit to which reference is made in the body of the contract. It is a key contract element that should be updated at least annually.

**c. Working Papers**

The firm's working papers must be available to its successor. These papers indicate the tax and accounting standards that have been applied to each client. They can also assist in determining the status of work in progress and can enhance the value of the practice. Arrangement for the transfer of these records must be made.

**d. Files**

Billing, personnel and other files must also be transferred to the successor firm. One of the most difficult problems can be locating the files and identifying the information they contain.

If a client chooses not to continue with your successor, copies of his/her files may be stored until the statute of limitations expires, at which time they may be destroyed. Any files stored off the premises should be brought to the successor's attention. For your own protection, you are advised to keep a copy of each client's files.

**e. Books and Financial Statements**

Should the entire practice is being transferred; the successor must have access to all of the predecessor firm's books. This includes subsidiary ledgers such as payroll and accounts receivable. It is also advisable that the firm's financial statements on an accrual and cash basis for at least the past 3 years be available. Tax returns should also be made available. Note that the same information regarding the successor firm should be available to the predecessor during negotiations and later on during reviews of the agreements.

**f. Work in Progress and Accounts Receivable**

One of the most difficult areas to define in a practice is the work in progress. Usually, it is valued separately. Payment therefore depends on the ability to identify and determine the status of the work in progress.

Accounts receivable records are also vital in the transfer of a firm's clients. The parties to the agreement must decide who will be responsible for collecting the accounts receivable and whether they will be valued and sold to the successor firm. If the successor agrees to buy them, they must remain separate and apart from the successor firm's accounts receivable records. Provisions should be made for any service fees that may arise in the collection process.

If the estate retains the rights to the collection of the account receivable but the successor is however engaged to collect and manage the account receivable, it must provide that the successor firm collects all the account receivable in the list even if the client does not remain with the successor firm.

**g. Equipment and Supplies**

A fixed assets subsidiary ledger, if it contains a record of dates of purchase, costs, serial and model numbers and peripheral attachments, can be used to assist in assessing the office furniture and equipment value in the balance sheet. If equipment and supplies are to be sold to the successor firm they need to be organized to allow an inventory to be taken.

**h. Existing Leases**

Generally, the successor does not need a second office in the same city and does not want to have to negotiate the settlement of the lease. However, to ensure client retention, a transitional lease may be arranged where appropriate. Successor firm could also lease equipment such as copying machine and have secondary leases for storage facilities. Assumption of payments and lease terms for these must also be addressed by the agreement.

**i. Employee Records**

Records should be available containing, at a minimum, employee contracts, salary scales, personnel policies and performance and salary reviews. Certain agreements contain a provision for the firm's personnel to be hired by the successor and to be retained unless they prove incompatible with the new firm. It is extremely important that your staff understand that the agreement provides for their transfer to the successor firm, where applicable.

**j. Liabilities and Professional Indemnity Insurance (PII)**

Existing and contingent liabilities must be identified, including any current professional liability lawsuits. Most agreements address this issue specifically. Successor firms do not want to be associated in any way with professional liability lawsuits brought by clients or with some contingent liabilities.

When a practice is to be continued by another practitioner, decisions have to be made concerning policy limits, deductibles, types of risks covered and settlement provisions. Of particular importance to you will be the purchase of tail coverage to protect against claims made after the expiration of the former malpractice policy. Work closely with your insurance broker and lawyers so that you can obtain the full protection of your PII policy.

Any debt such as notes payable or current liabilities should also be identified in detail. Before negotiations can be completed, these debts may have to be negotiated with the creditor. Some debts cannot be assumed and new ones may have to be created or substituted.

**k. Property and Casualty Insurance**

This element of the agreement is of special interest to the successor firm. Proper coverage must be in force and expiration dates must be known to ensure protection of assets before and during transfer from one office to another.

The surviving spouse or heirs also need coverage to be in force until they have disposed of any assets not transferred. A well-organized insurance file containing records of all current policies is recommended.

**l. Fees and Billing Information**

The standard fees of your firm and your successor need to be known during negotiations. Compatibility between these fees in the market place is required to ensure client acceptance. The fee structure of billings and the billing procedures themselves are also vital to client retention. Finally, utilization of personnel is determined principally by the fee structure.

**m. Payment for the Practice**

When considering the sale of your practice, you must be reasonable in your assessment of its value and realistic in the payment structure you demand. You must keep in mind that the object of your negotiations is a practice continuation agreement that protects your assets and provides something to your surviving spouse or heirs.

You must also remember that the value of your practice will dissipate in less than 30 days after your death and that it will not last much longer than that if

you become permanently disabled and are unable to tend to its affairs. It is essential in your negotiations and in the drafting of the agreement that payment steps are clearly outlined. Consideration of tax issues and responsibilities is also critical.

**n. No competition Clause**

It is extremely important to have this element addressed in your agreement. A no competition clause penalizes your successor for taking away any clients before the agreement comes into force. The penalty can be in term of dollars to be paid for each client taken.

**o. Termination of the Agreement**

Most agreements allow for termination by either party within 30 days of sending written notice to the other's last known business address. However, you can select any termination period. You need this provision to allow you to void the contract in the event of the discovery that your successor has been involved in controversial issues that might jeopardize retention of your clients.

A significant change in financial conditions at either firm could also warrant termination of the contract. There may be other instances in which you wish to draw up a new agreement, for example, in order to transfer the practice to a particular staff person who has gained the respect of clients. The successor may also want to cancel, for example, if his or her health deteriorates.

**p. Arbitration**

The parties can agree that any dispute or claim concerning the contract will be settled by arbitration.

**q. Notification**

This element of the contract ensures that your clients are notified of the agreement. It should be stressed to them that the services they have been receiving would not be interrupted in the event of your untimely departure from the practice. Notification should be performed by your firm and should make the point that much thought has gone into finding a successor firm that will provide comparable services at comparable rates.

It is even advisable that both you and your successor visit key clients before the agreement is consummated and inform them of the possibility of a transfer and what they can expect. It is also extremely important that your surviving spouse or heirs be notified that you have executed a practice continuation agreement. The lawyer for your estate should also be notified if he or she did not review your practice continuation agreement before execution.

**r. Carryover Expenses**

Generally, your staffs are paid by your estate through the date of transfer and by your successor thereafter. Employee benefits such as accrued sick pay and vacations are important for morale and should be addressed carefully.

**s. Other**

Consider circumstances peculiar to your own or your successor's practice during the negotiations and include them in the agreement. Incorporate the practice continuation agreement into your will and estate and consult legal advice in drafting your agreement and review all related documents at the conclusion of negotiations.

**Section 6**

**PAYMENT METHOD**

There may be some combinations of payment methods for different types of assets e.g. tangible or intangible assets.

For the payment of tangible assets, for example, it may be made upon transfer of the legal title or any other methods that are agreed upon between the parties as stated in the continuity agreement. This is similar to an outright buy/sell process.

While for the intangible assets, the payment method that protects both you and your successor is one that is directly related to the client list and the values assigned to each individual client, so called the *Client List Method*. Predetermined client value (as mentioned in Section 3) is used to create a payment ceiling that reflects the maximum to be paid not only for the entire practice, but for individual clients as well. This requires a separate accounts receivable subsidiary ledger to handle the administration of collection for each account. The separate accounts receivable subsidiary ledger set up for this administrative purpose should facilitate an audit, where required.