

Attorney CLE Series



Exit Planning

UNDERSTANDING THE CONSIDERATIONS AND STEPS FOR EXITING A BUSINESS

presented by GYF Business Valuation Services



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants



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After graduating from Saint Vincent College in 1979 with Highest Honors in Accounting, Bob earned a Masters of Science degree in Taxation with Honors from Robert Morris University. He is a CPA in Pennsylvania and Ohio and is accredited in Business Valuation by the American Institute of Certified Public Accountants. Bob also carries the well-recognized credentials of Accredited Senior Appraiser, Certified Valuation Analyst and Certified Business Appraiser.

A member of the American and Pennsylvania Institutes of Certified Public Accountants (PICPA), Bob has previously chaired the Pittsburgh Committee on Taxation. He has also served as Chair of the Executive Advisory Board of NACVA, its highest Board; as well as Chair of NACVA's Professional Standards Committee and its Education Board.

Bob received the NACVA "Thomas R. Porter Lifetime Achievement Award" for 2013. One award is presented annually to a single member, from the organization's 6,500 members, who has demonstrated exemplary character, leadership and professional achievements to NACVA and the business valuation profession, over an extended period of time. He was also named as an "Industry Titan" by NACVA in 2016.

Bob is a member of the Allegheny Tax Society, the Estate Planning Council of Pittsburgh and the American Society of Appraisers. He has held numerous offices and directorships in various not-for-profit organizations. Bob received the 2003 Distinguished Public Service Award from the PICPA and the 2004 Distinguished Alumnus Award from Saint Vincent College.

Bob and his wife, Susie, live in Westmoreland County. They have two grown children.



Melissa A. Bizyak, CPA/ABV/CFF, CVA



Melissa has practiced in public accounting for over 20 years and has significant experience in business valuation and tax-related issues for privately-held concerns and their owners. Melissa's business valuation experience is very diverse, including valuations of companies in the manufacturing, oil and gas and technology industries. These valuations have been performed for various purposes such as financial reporting, equitable distributions, buy/sell transactions, dissenting shareholder disputes, Employee Stock Ownership Plans (ESOPs) value enhancement and gift and estate tax purposes. Melissa also provides litigation support services including expert witness testimony.

After graduating from the University of Pittsburgh in 1994 with a B.S. in Business/Accounting, Melissa spent more than two years with a local accounting firm in Pittsburgh. She joined Grossman Yanak & Ford LLP in 1997.

Melissa is a certified public accountant. She is accredited in business valuation and certified in financial forensics by the American Institute of Certified Public Accountants (AICPA). She has also earned the AICPA Certificate of Achievement in business valuation. Additionally, Melissa carries the credentials of Certified Valuation Analyst.

Her professional affiliations include the AICPA and the Pennsylvania Institute of Certified Public Accountants (PICPA), as well as the Estate Planning Council of Pittsburgh. She is also a member and serves as the Chair of the Executive Advisory Board of the National Association of Certified Valuators and Analysts (NACVA).

Melissa has authored articles appearing in professional publications. She has written business valuation course-related materials and serves as a national instructor for NACVA.

Melissa is a graduate of Leadership Pittsburgh, Inc.'s Leadership Development Initiative. She serves on the Board of Directors of the Children's Museum of Pittsburgh and is a member of the Executive Leadership Team for the American Heart Association's "Go Red for Women" initiative. Melissa also mentors women business owners through Chatham University's MyBoard program.

She lives in the South Hills of Pittsburgh with her husband and their two sons.



Brad Matthews, CPA, CVA



Brad has practiced in public accounting for five years. He primarily serves privately-held concerns and their owners. Specifically, Brad focuses on providing valuation and litigation support services. His experience includes financial statement and historical financial trend analysis, financial modeling, business risk assessment, as well as performing calculations required for the preparation of business valuations and other consulting projects.

Brad has served clients in many industries including manufacturing, professional services, financial services, engineering, construction, retail, management consulting, oil and gas, and technology. He has played a significant role in providing business valuation services for a range of purposes including gift and estate tax planning, Employee Stock Ownership Plans (ESOPs), marital dissolutions, corporate divorce/shareholder disputes, financial and tax reporting, buy/sell transactions, and general business planning. Further, his litigation support experience includes the determination of lost profits and economic damages arising from various disputes.

Brad graduated from the University of Pittsburgh in 2011, earning a double major in Accounting and Finance with a minor in Economics. After graduation, he joined the Business Valuation & Litigation Support Services Group at Grossman Yanak & Ford LLP.

He is a certified public accountant (CPA) and has earned the Certified Valuation Analyst (CVA) designation conferred by the National Association of Certified Valuators and Analysts (NACVA).

In his spare time, Brad enjoys golfing, following Pittsburgh sports and spending time outside with his family. He lives in the North Hills with his wife, Alexis.



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Exit Planning: Considerations & Steps for Exiting a Business

Introduction: Understanding the Need for Exit Planning

Arguably, there may be no other hotter topic among professional advisors and business owners than exit planning. The growth in this seemingly-specialized niche can be almost overwhelming. One need only to look online at www.exit-planning-institute.org to learn how you might become an “expert” Certified Business Exit Consultant (CBEC), [requires two days of online training, five days of group training and a four-hour examination]. The certification comes after you have written, delivered and received payment for an exit plan to an actual business owner. Similar programs provide the Certified Exit Planning Advisor (CEPA) designation, and the list goes on.

Insurance companies, accountants, financial advisors, attorneys and exit planners (whatever that term may connote) are constantly attempting to express a specialization in exit planning, and are selling this service as a separate stand-alone offering. Last weekend alone, there were three “free” exit planning seminars offered at local restaurants and hotels.

Why the big emphasis on exit planning?

According to a 2016 report produced by the [Insurance Retirement Institute](http://www.insurance-retirement-institute.com), there are nearly 76 million baby boomers in the United States, and more than 40 million of them (about 53%) are already age 65 or older.¹ Another article, “[Here Come the Boomer Biz Owners](http://www.wealthmanagement.com/retirement-planning/here-come-boomer-biz-owners),” published by [Wealth Management Magazine](http://www.wealthmanagement.com), reported that there are nearly 12 million baby boomers who own a business, and 70% of them will be retiring over the next couple of decades.² This is a huge opportunity, as estimates of the total wealth connected in these companies run in the trillions of dollars. Many of these business owners have been holding off on selling due to the weakened economy, but now that the economy is starting to improve, business values have rebounded, and these owners are looking to sell.

The goals and motivations of the Baby Boomer generation are influenced heavily by concerns and fears about the economy and retirement risk. One telling statistic, which serves as a cautionary note for this generation, is the degree of growth that has occurred in the national debt. In the fourth quarter of 1970, when the oldest Boomers were in their twenties, total public debt was 35.7% of Gross Domestic Product (GDP). At the end of the second quarter of 2016, the national debt has nearly tripled to 105.1% of the GDP.³

¹ *Boomer Expectations for Retirement 2016*, [The Insurance Retirement Institute](http://www.insurance-retirement-institute.com), 2016

² *Here Come the Boomer Biz Owners*, Mark Miller, [Wealth Management Magazine](http://www.wealthmanagement.com/retirement-planning/here-come-boomer-biz-owners), January 11, 2013, <http://www.wealthmanagement.com/retirement-planning/here-come-boomer-biz-owners>

³ FRED® Economic Data, Economic Research – Federal Reserve Bank of St. Louis, *Federal Debt: Total Public Debt as Percent of Gross Domestic Product*, <http://research.stlouisfed.org/fred2/series/GFDEGDQ188S>



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In addition to those businesses owned by the Boomers, each new generation seems to have more and more of an entrepreneurial bent, moving towards an economy of self-reliance and independence. Business owners that are part of Generation X (people born between 1966 and 1975), while younger and with a longer time horizon until retirement, face an even-harsher, uphill battle. Business challenges facing these entrepreneurs include an increasingly-volatile business and economic environment, an overreaching and defeatist Internal Revenue Code and a level of government regulation and legal risk not faced by any other generation in the past. In addition, global competition – both physical and virtual – presents greater competitive pressures than those faced by earlier generations.

In an article titled, “*Gen X Getting in a Retirement Tizzy*,” posted by USA Today on June 6, 2015, the author referenced a survey done by Northwestern Mutual on Financial Planning and Progress. The study found that Generation X respondents reported the highest levels of financial insecurity. Two-thirds of the respondents said they expect to have to work past traditional retirement age out of necessity, and 18% believe they will never retire.⁴ Generation X is the first generation to experience the shift from traditional pension plans to 401(k)s and individual retirement plans, and they will achieve retirement age around 2033, just as the Social Security program’s trust fund is expected to run dry.

Between the two generations, opportunities abound for business exit planning. Such a need demands that accountants and attorneys join the fray in attempting to assist business owners in develop sound and meaningful planning strategies to exit their businesses and move efficiently and comfortably into retirement.

The question remains – exactly what is meant by this “new” specialty?

In reality, exit planning is not a new kind of magical solution to the problem of gracefully leaving a business in the most economically-beneficial manner possible. To view exit planning as a new idea and concept is to dismiss all of the planning undertaken by those generations of business owners and advisors that have preceded us. Exit planning cannot be shaped into a “one-size-fits-all” solution to the quandary of how, and when, is best to exit a business. In fact, exit planning is an integration of many complex disciplines, including legal principles, economics and accounting considerations, investment strategy development, retirement planning, business succession planning, income tax planning, estate and gift tax planning, charitable giving strategy development, and life and health insurance planning. The disciplines invoked in any exit planning process will be as diverse as the facts and circumstances attendant to that particular business owner.

⁴ *Gen X Getting in a Retirement Tizzy*, USA Today, June 6, 2015, <http://www.usatoday.com/story/money/2015/06/06/generation-x-retirement/28571965/>



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More important than any of the technical disciplines noted above are the wishes and desires of the business owner. Often the contemplation of a business exit can be extremely difficult for the owner. It is not hard to envision business owners struggling with the decision after a lifetime of effort. In many cases, the business is a reflection and alter-ego of the business owner. For that reason, technical advisors need to be cognizant of the emotional aspects of the exit planning process at all times and be attentive to the ongoing dynamics surrounding the business owner, while still staying on task to see that the agreed and properly-crafted strategies are, in fact, executed and implemented. Most often, the greatest barrier to business owner exit by the most beneficial means possible is procrastination on his or her part, focusing more on day-to-day operations than his or her own future well-being.

At the core of any business owner exit strategy is the business, itself. In almost every case encountered by these authors, it has been our experience that the business, or an ownership interest therein, comprises the largest asset in the business owner's financial estate and investment portfolio. Because this asset is so substantial, it generally stands at the center of any exit planning strategy. While this is a seemingly-obvious conclusion, the disposition of the business or that ownership interest is not.

While many business owners contemplate a large "pay day" when the business is sold at some future point in time, such is not always the case. Many businesses are family-owned with multiple generations of family members involved in the conduct of that enterprise. In these businesses, the goal of transferring ownership to junior-generation family members may take precedent over selling the business for a large sum of money. In others, the owner(s) may have a deep commitment to employees who have contributed to the company's growth and success. Such circumstances have often directed the planning that was required to facilitate the owner's exit. In other cases, the business owner may have significant charitable inclinations which drive the process.

The business owner's motivations and desires set the core "mission statement." This mission will depend upon his or her current and future financial situation and circumstances surrounding the business. For example, if it is his or her desire to move the business to junior-generation family members or some employee group, the mission may be to exit the business through means other than a traditional strategic sale, as might be the case if the entire business were to be sold. Rather, some combination of gifting ownership and a sale at financial value might be in order.

In accomplishing this mission, consideration will go to the age and health of the owner and his or her spouse. It also requires a careful consideration of all assets held by the owner(s) and the means by which those assets can be used to meet the future economic needs of the business owner(s). Such assets are those common to most families, including real property, after-tax investments and savings accounts, qualified retirement accounts and unqualified deferred compensation accounts, cash surrender value in life insurance contracts and other financial contracts (such as annuities). Collectibles and other personal property are sometimes considered if those assets can be reasonably converted into cash.



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Offset against this collection of assets and stream of income are all the reasonable costs associated with maintaining the business owner's lifestyle at the level he or she desires. Such costs include housing, food, clothing and personal items, healthcare/medical expenses, automobiles, travel, gifts and entertainment, among others. It is critically important that any exit strategy consider, first, and foremost, the provision of sufficient income to maintain the desired lifestyle.

On the other hand, if a sale of the business is contemplated, the preparation and the structure of the transaction will have a significant impact on the amount of proceeds the business owner can expect to "net" from the transaction. Planning for the maximum net proceeds very often positions the business owner against the needs and desires of the buyer. As such, in most cases, the best situation for the selling business owner will not be to yield his or her best possible outcome but, rather, a negotiated outcome somewhere between that which would be best for him or her and that which would be best for the buyer. In these instances, it is also critical to understand the potential income stream associated with expected investment of the net proceeds and how this income stream fits into the business owner's overall future needs.

These materials are intended to familiarize today's participants with the general concepts of exit planning and how those in the legal community can work with others involved in the exit planning process to obtain optimum outcomes for business owners. While many of the concepts discussed today will not be new to many in attendance, we expect that it might be a fresh idea to look at these ideas and planning opportunities as part and parcel of the exit planning process. In reality, we have worked over a great number of years with many of the people in attendance to develop integrated strategies intended to optimize business owner exits. We would expect to continue this joint effort of leading the charge in this area with our friends and contacts in the legal profession.

Today's program is separated into four separate chapters, intended to encompass a general overview of the entire exit planning process. The course is structured as follows:

- Introduction
- Chapter I – Developing the Objectives of the Exit Plan and Considerations for the Exit
- Chapter II – Understanding the Various Options for Exiting a Business
- Chapter III – The Exit Process: Identification of Steps and Who Should Be Involved
- Chapter IV – A Brief Illustration of Exit Planning
- Conclusion and Practical Observations



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As with all two-hour continuing legal education programs, it is not expected that you will leave today as an expert in all aspects of the concepts discussed in these materials. Rather, it is our hope that you will be able to assimilate some of the ideas into fact patterns you might have encountered in your practices in the past, or even those facing your clients today. With a focus of applying these ideas to your clients that are business owners, you will begin to sense the opportunities available to all of us as we render those truly-important services of helping business owners exit their businesses in an orderly and economically-beneficial fashion.

Thank you for attending today. We do appreciate that all of you are exceedingly busy, and to have you spend part of your day with us is an honor and privilege for Grossman Yanak & Ford LLP. Should you have further general questions, comments or observations, please feel free to contact us directly.

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Chapter I – *Developing Objectives of the Plan & Considerations for the Exit*

As noted in the introduction, the objectives are, in effect, the mission statement of the entire exit planning process. These objectives are inextricably tied to the desires and wishes of the business owner and work to overlay all outside intervention from attorneys, accountants and other financial advisors. The objectives of the business owner are at the foundation of the process and will guide the advisor team through the exercise, hopefully resulting in a plan that facilitates accomplishment of each of the objectives or goals.

Depending on the depth of the objectives determined at the outset of the exit planning process, the course of the plan may vary. For example, if the business owner is focused, first and foremost, on an outright sale of the company, the need to drill into certain personal information of the business owner may not be required. Alternatively, if it is the goal of the business owner to transfer the business as cost-efficiently as possible to his or her children who are involved in the business, he or she may wish to enter into a gifting strategy envisioned to move a substantial portion of the company without any future payments from the children. In such an instance, it will be necessary to delve into the personal financial information of the business owner to ascertain the future expected expenses associated with his or her lifestyle, and then explore the assets and income streams that are going to be available to facilitate sufficient future cash flows to meet these needs. The same implications may arise if the objectives of the business owner are philanthropic. In this case, there may be significantly fewer proceeds than what would otherwise be available as a result of transferring the business in an outright sale. Such an objective will lead to consideration of the various ways to accomplish the business owner's exit planning objectives, while still providing sufficient monies to fund future lifestyle needs and wishes.

The balance of this chapter will address the general considerations associated with a variety of business owner objectives, as well as many of the issues that require attention from advisors working with that individual. The content is not intended to be all-encompassing, as it has been the authors' experience that necessary considerations are as varied as the specific facts and circumstances attendant to each situation. As a result, it would likely be impossible to draft materials that are inclusive of every possible situation. The purpose of the discussion is to allow for some understanding of the exit planning process and exactly how and when certain steps should be undertaken. It will also note how members of the legal community might be able to step in at certain points and bring value to the process.

Preparing for the Sale of the Business

A sale of the business, as well as alternatives to an outright sale, are discussed in more detail later in these materials. An obviously-complex undertaking, with many facets of technical challenge attendant thereto, the dis-



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cussion here is intended to facilitate the initial thought process that is (or should be) part of that business owner's decision in moving in this direction.

First, a decision to sell the business is one that should be made at a point in time well ahead of the timeframe expected for the actual business owner exit. In the context of privately-held businesses, converting that enterprise into cash at the closing of a transaction is a long-term process. If the business owner is not currently being courted for a potential sale, the time to prepare a company for sale, market that company, successfully negotiate an agreement for the sale, allow for the conduct of transaction due diligence by the buyer and, ultimately, close the sale can be long. We have observed the timeframe to last several years or more.

In addition, it is not unusual that business owners with a long-standing history with the company being sold, and especially with a relationship with the customers, to be required by the buyer to enter into a post-sale employment agreement for some length of time to facilitate a smooth and orderly transition to the new ownership group. These agreements, in the experience of the authors, generally run for between two and five years, with three years being somewhat of a norm.

Thus, while the sale decision and resultant objectives may at first look like a clean break from the business, allowing the owner to step away and exit gracefully, such is often not the case. The period of time between the decision to sell and the time at which the business owner is able to enjoy his or her "post-exit" life can be lengthy.

The most-significant aspect in the above process is preparing the business for sale. It is also the aspect of the process that may require the most time. While this topic could easily be expanded into a full program, the high points of such an undertaking are touched on here.

Preparing a business for sale is critical to optimizing the position of the business owner and maximizing the net proceeds to accrue to him or her as a result of the sale. An important part of this preparation is to identify the value drivers in the business and to fully understand how they can be improved to facilitate an increase in business value. In making this determination, it is critically important to keep in mind that buyers are looking for free cash flow. Free cash flows are those amounts of cash flows that can be distributed from the business in the future without interfering with the continuing operational capabilities for the business to generate projected cash flows. In other words, free cash flows constitute the return on investment that any prospective buyer might enjoy as a result of an investment in the particular business.

Keep in mind that, often, buyers are unable to discern free cash flow when contemplating the purchase of a business. Such is the case with public companies. In these instances, buyers defer to EBITDA, which is defined as earnings before interest, taxes, depreciation and amortization. In effect, EBITDA serves as a proxy for free cash flow and allows for an estimate of that variable, albeit on a broader basis.



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The basic concept of valuation is simply to divide future expected economic benefits (projected free cash flow) by a rate of return that encompasses the risk associated with the particular investment. For example, if free cash flow is expected to be \$1,000, and the risk rate required to draw an equity investor to contribute capital to the company is 20%, the estimated value would be \$5,000. In applying the EBITDA multiple method under a market approach, assume that future EBITDA is projected at \$1,000, and that the appropriate multiple is found to be five (5). In this instance, applying the multiple to projected EBITDA results in a valuation of \$5,000.

Understand that increasing cash flows will lead to a higher valuation. An inverse relationship exists for the risk rate determinations and the EBITDA multiple determinations. In these instances, an increase in the risk rate or EBITDA multiple results in a lower valuation; higher EBITDA multiples lead to higher values.

In preparing a company for sale, the business owner has two primary avenues in which he or she can improve the valuation of the company. The first, of course, is to increase expected free cash flow in the future. In essence, this is done line-item by line-item on the income statement, as well as through underlying operational initiatives that generate those numbers. For example, increasing research and development activity, while costing more dollars today (and thereby decreasing free cash flow) may lead to development of products that can be sold into the marketplace at increasing gross margins beyond where the business is at the current date. Another example might be to incorporate a plan to expand current product offerings into new geographic regions or offshore to address potential customers that have not been the subject of company focus in the past. A third possibility might be to add sales staff or new marketing techniques to push current products harder.

While each of these concepts could lead to greater free cash flows, it is important to understand that they all come with a certain cost structure, most of which is variable. However, growing revenue, in any way, also leads to some degree of fixed cost increase, which should be part of the considerations in preparing the company for sale. Lastly, it must not be forgotten that growth in revenue requires reinvestment of some level of cash flow into working capital and, potentially, capital expenditures.

Another way to increase expected free cash flows is through cost containment. To the extent the costs are streamlined and expected to be lower going forward (as a percentage of revenue), the greater the valuation. The primary issue in implementing cost-containment strategies is the risk associated with business problems that may fall through the cracks if resources are not available to address them. In such situations, it may actually have the long-term effect of diminishing free cash flows. As such, in preparing a business for sale, it is necessary to carefully craft cost-cutting strategies that are logical and reasonable and that do not detract from the positives already in place at the company prior to adoption of those strategies.



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The second primary avenue for improving the value of a company is through risk reduction. As noted above, the risk rate in the simple example presented was 20%. Understanding why this rate is at that level and taking steps to reduce the rate will lead to higher values.

It must be understood that the risk rate is the amount of economic return that any particular investor might require to invest in this particular business enterprise. As such, the rate represents an opportunity cost and is specific to the investment (i.e., the company) and not the investor. The resultant planning opportunity in preparing a business for sale is to take management actions that will lead to decreasing risk inside the company and, thereby, will reduce the required rate of return.

By way of example, two very common considerations specific to any particular privately-held company are “thin management” and “concentration of customers.” In addressing each of these issues individually, steps can be taken in the process of preparing the business for sale where the risks are eliminated.

Assume that the business is managed by a single individual, resulting in a “thin management” issue. This individual is the only equity owner and runs the financial, as well as the operational, functions of the business. Finally, this individual has had, and continues to have, the key relationships with the company’s customers. The company does have a controller, as well as a shop foreman and a sales manager. However, each of these individuals reports directly to the business owner. In effect, in this situation, the owner is absolutely critical to the future well-being of the enterprise. If he or she should have some life event that limits his or her capabilities for any period of time, the expected future free cash flows associated with this business would be at substantial risk.

The strategy to improve value in preparing the business for sale is quite simple under this fact pattern. Circumstances dictate that greater management responsibility has to be transferred to those people reporting to the owner and that the company be groomed to operate, as much as is reasonably possible, without him or her. Such changes will tend to mitigate some of the risk associated with the thin management issue, thereby decreasing the risk assessment by any potential buyer. As a result, the business value will increase.

Similar obvious planning also relates to the “concentration of customers” issue. Assume that the company has revenue of \$1M, but two significant customers account for 80% of that total. Assume further that these top customers are not under any kind of long-term contract and, thus, have the capability of moving to another vendor, even without cause. In this instance, a potential buyer would discount the value of the business by a substantial sum, justifying the downward adjustment by accentuating the risk to future free cash flows associated with the loss of either of the two key customers.



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The remedy, though clear, is not easily accomplished. The business owner, in preparing the company for sale, can alleviate a portion of the risk attendant to this customer concentration issue by diversifying the customer base. The steps necessary to procure a sufficient level of diversification to completely mitigate this risk are varied and may be dependent on long-term sales and marketing strategies. Additionally, the business owner may need to expand product offerings into other markets to allow for a dilution of the effect of the current customer concentration.

If the free cash flows in the example company were increased by \$200 by virtue of the strategies outlined above, total expected cash flows would rise to \$1,200. Assuming the risk rate is unchanged, the value would increase to \$6,000 ($\$1,200/.20$). Alternatively, if free cash flows remained constant, but the risk rate was dropped to 16.5%, the value would increase to \$6,060 ($\$1,000/.165$). Of course, a combination of both strategies would increase the value even more.

This impact of undertaking these types of management initiatives in preparing a business for sale is always far greater when they are focused on the current value drivers. Generally, those aspects of the business that are driving the value up are those that are already better managed by the business owner and not in need of great change. Simply focusing more on the areas in which the company is strong will be easier to modify as a potential sale comes into view.

What should be apparent is that adjustments, such as those noted above, take time. For that reason, it is seldom in the best interest of the business owner to rush into a sale transaction without some consideration of the value modification opportunities available and the time commitment necessary to implement them. As such, it is the opinion of the authors that it always best to consider exit timing as part of the overall exit strategy and to think of this timing as early as possible in the lifecycle of the business.

Once the business has been “dressed” for sale, those processes that are always part of the sale strategy can be invoked. The advisors involved with this process generally include, at a minimum, quality experienced legal counsel, experienced accountants/tax advisors and an investment banking firm. This team will work to create a slate of interested buyers – in effect, allowing the company to be auctioned to the highest bidder, or the most lucrative deal. Details of this process will be discussed later in these materials.

The opportunity of preparing a business for sale may not be available should the business owner have an interest from outside parties at the current time. The objective in this circumstance, if present, is the same as the objective in all third-party business sales – maximization of net proceeds. In these circumstances, decisions will run to whether the consideration and terms offered in any particular letter of intent are sufficiently attractive to move away from other bidders. If that is the case, most often, the transaction will proceed. If not, there may be a need to engage an investment banker to ensure that alternative buyers are identified and brought to the table.



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to submit competitive bids. Legal counsel, as well as tax advisors, may also be involved at this point to allow for a better understanding of deal structures and the economic and tax implications of any proposed transactions.

No matter the course of the business sale, in planning for a successful exit, the business owner must be concerned not only with the amount of “net” proceeds arising from the sale, but also the timing of the proceeds, as well as the risk associated with deferred proceeds. The integration of deal payment alternatives with business owner financial needs is rarely addressed in conjunction with the sale of a business. Oftentimes, the two concepts are treated as mutually-exclusive when, in fact, in many cases, the two are significantly interrelated. Understanding future income and cash flow needs on a personal level can assist the business owner with structuring transactions for the sale of his or her business. He or she can focus on options that are more conducive to addressing immediate needs, improving his or her security in deferred amounts due in the future, and timing income streams arising from the sale of the business to his or her optimum tax position.

The final factor that should be addressed in consideration of a sale of the business, as mentioned briefly earlier, is the likely scenario that will require the business owner’s continuing employment with the buyer. Depending upon the personal post-sale life plans of the business owner, this may or may not be an issue. The keys to understanding the integration of this issue into exit planning are the age and health of the selling business owner at the date of sale, the buyer’s specific requirements for his or her responsibilities imposed in the employment agreement, and the term of the agreement. Not to be dismissed in the seller’s considerations is the psychological “challenge” of working for a third-party employer post-sale.

Transfer of the Business to Family Members or Employees

A transfer of a business to junior-generation family members or, alternatively, an employee or employee group that has contributed to the overall success of the company is a very different exit strategy. This option requires that the business owner carefully assess future available income streams against those costs associated with his or her life-style choices. Differing strategies exist depending upon whether the transferee(s) is/are family or employees and, within those two differing groups, whether or not the selling business owner requires some element of monetary consideration in exchange for the transferred ownership.

Again, a close and detailed understanding of the selling business owner’s future needs, as compared to alternative source income from nonqualified deferred compensation agreements, qualified retirement plans, social security income, and other savings and assets, will allow the exit planner to accurately determine how much consideration will be required from the transfer. This understanding will lead to a balanced transaction that will allow accomplishment of the business owner’s objectives and wishes, while still ensuring that he or she is in possession of sufficient assets and income streams to always be comfortable.



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Business transfer strategies can vary widely based upon whether the business owner is transferring ownership to family or employees. In many cases, business owners will transfer business interests to family members with no strings attached, except for restrictions on future transferability. These transfer strategies, for the most part, are generally accomplished through the gifting of equity interests, either annually or through periodic or single substantial gifts (with value beyond the annual federal gift tax exclusion – currently, \$14,000). The thought-process behind this strategy is that the transfer not only accomplishes the goal of the business owner relinquishing ownership, but it also integrates nicely into business succession planning and federal and state estate planning. Usually, the strategy of gifting ownership does not carry with it any obligation for the person receiving the gift to remit any type of monetary remuneration back to the transferor business owner.

The issue of valuation becomes important in conjunction with these gifting strategies, and planning may be extended to modification of capitalization structures of the business being transferred so that the entity holds an equity structure that contains both voting and nonvoting ownership interests. Generally, the purpose of such re-capitalizations is to facilitate a reworked capital structure with a sufficient number of capital shares to accomplish the necessary gift planning strategies that are recommended by the advisors and desired by the business owner. It also allows for leveraging the annual gift tax exclusion and the lifetime exclusion through the use of valuation discounting for the investment risks of lack of control and lack of marketability.

An important benefit of gifting ownership on an annual basis is the ability to move equity ownership, and value, out of senior-generation estates that might be subject to death taxes and, at the same time, facilitate the accomplishment of business succession. The issue that arises on a regular basis, however, is that the business owner often has multiple children, some who have been and remain active in the business, and some who are not active in the business. In these instances, it is necessary to assess the overall value of the business owner's estate to determine if he or she has sufficient "non-business" assets to make equitable distributions to all of them. In the instance that the business owner has been able to successfully accumulate other assets beyond those that he or she will require for his or her lifetime expenses that are sufficient to remedy this problem, the resolution is rather simple.

On the other hand, the business ownership interest often constitutes the largest asset in the business owner's estate. In this case, the equalization of the "non-active" children may require some creative legal and tax planning to ensure an economic balance among the junior generation. One strategy, used in many cases, might include gifting equity ownership interests, either voting or nonvoting, to the non-active, as well as the active, children and providing for the repurchase of those shares by the active children or the company at a later date. This is just one example of a common problem encountered in the process of transferring a business ownership interest through gifting.



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Different avenues are available should the business owner's objective be a transfer of the business to an employee or employee group. In these instances, absolute altruism, as is usually associated with family transfers, is not present. As such, employee transfers are often accompanied by economic implications for the benefit of the business owner.

A common practice for moving equity ownership to employees is through the provision of equity in exchange for personal services. Oftentimes, this is accomplished with equity options or actual equity shares. The resultant transaction is one in which the employee receives "non-cash" compensation equal to the fair market value of the transferred property, less any amount that he or she might be required to pay for the property. This transaction, governed by the Internal Revenue Code for federal income tax purposes, results in a tax deduction to the company equal to any income recognized by the employee. The resultant tax savings are akin to additional cash flow. Thus, even if the business owner elects not to have the employee pay any amounts for the transferred equity interests, some value inures to him or her as a result of the tax savings.

A second means of accomplishing the business owner objective of transferring ownership to employees is through a sale of all or part of the business to the employees. While this strategy is discussed in detail later in these materials, the obvious consideration for the business owner is where the transaction proceeds might come from to consummate the transaction. It is generally unlikely that members of the employee group will have ample funds to purchase the business at the outset of a sale. This strategy is more likely to be accomplished if the business owner is willing and, more importantly, able to "hold a substantial portion of the paper" on the deal. In other words, the business owner must be willing to finance the acquisition of his or her own business and accept the security risk associated with such a financing arrangement.

Note that the security risk in this situation is generally handled through collateralizing the equity interests into the financing agreement. However, selling business owners have to be concerned with stepping back into the business in future years when the employee group may be unable to service the debt obligation to the business seller. A substantial amount of this deferred payment security risk can be offset with careful planning and well-crafted financing agreements. However, the reason the business owner is financing the employee purchase in the first place is the inability by that buyer group to obtain conventional financing. As such, these types of transactions are not without risk at any point.

Another way to sell shares to employees is through the use of an employee stock ownership plan (ESOP). This strategy involves the creation of a qualified plan. Under the Employee Retirement Income Security Act of 1974 (ERISA), the plan is able to invest plan assets primarily in sponsor-company securities. The advantages to using an ESOP are numerous, though the benefits come at the cost of increased transaction complexity. If properly struc-



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tured, an ESOP can be an advantageous mechanism for the selling business owner, the company itself and, finally, the participating employees. As explained in more detail later in these materials, an ESOP offers the opportunity for the business owner to receive fair market value consideration for the shares sold to the plan. It can also serve well as a vehicle to meet succession planning needs of the business owner.

One key benefit of these business transfer strategies is for the business owner to move small-percentage ownership interests over time and, thereby, remain active in the company. Each of these strategies also allows for the maintenance of a control ownership position so that management decisions rest solely with the transferring business owner until more than 50% of the voting interest is transferred. Such flexibility is of great assistance to the business owner, and his or her advisors, in timing the eventual full exit from the enterprise. During that interim period of continued involvement, the business owner can maintain his compensation structure, including fringe benefits. Thus, such strategies allow for continuing involvement and participation in all retirement and savings plans, as well as compensation payments and draws, enabling greater savings build-up prior to full exit.

Each of these business transfer strategies is useful in the right circumstances. Care must be taken by the advisor team to ensure that the facts and circumstances of each business owner's situation are fully understood so as to not gain an economic benefit on one turn, while generating an economic detriment on another. It is also useful to understand how these business transfer and exit strategies do not necessitate an immediate full exit but, rather, allow for a staged exit.

Philanthropic Business Transfers

For those business owners who do not have family members or committed employees to succeed them at the helm of the business, or for those who are simply inclined toward charitable giving, philanthropic business transfers allow them to move the wealth, or a portion thereof, that they have accumulated in their businesses to charitable organizations. If philanthropy is the objective of the business owner, transaction structures can be developed, whereby more monies are available for charitable use than what otherwise might be available in a conventional sale of the business. Most often associated with the sale of the business to outside buyers, the transactions generally occur in one of two ways.

The first transaction structure anticipates a pending sale of the business. There may be an opportunity to facilitate a transfer of the equity ownership interest prior to the sale of the business. The intent of such a transfer is to allow ownership to change hands prior to the sale so the tax burden associated with the transferred ownership interests flows to the charitable organization. At this juncture, the business owner is generally entitled to a



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federal income tax deduction equal to the fair market value of the equity interest transferred. Assuming that the business owner is subject to the highest marginal income tax rates, the associated tax savings can be substantial.

In further consideration of the economic merits of such strategies, the gain on the sale of the equity ownership interests transferred to the charitable organization are not subject to any tax, given the federal (and, often, state) tax-exempt status of the recipient organization.

The cash flow trade-off for the business owner under this type of strategy is that there are no proceeds associated with the transferred equity ownership interest that will inure to his or her benefit. As such, future life expenses, as discussed earlier, must be satisfied with alternative sources of income and assets. Once the equity ownership interests are directly transferred to the charitable organization, there are no further business owner holds on those assets. Thus, to give away the equity ownership interests is to also give away the rights to any future income from those assets.

One alternative that offers a slight twist on this strategy is to use a charitable remainder trust as the framework to facilitate the philanthropic wishes of the business owner. This vehicle allows for directing the remainder interest in the trust to a charitable organization, while allowing the business owner to have a continuing income interest in the trust from the investment of the assets received from the sale of the business. If the strategy is designed correctly and applied in a manner consistent with the rules, the business owner will obtain a federal income tax deduction equal to the fair market value of the remainder interest, effectively discounted back to the date of contribution based on his or her life expectancy and discount rates established under federal income tax rules. In addition, and likely more important in many situations, the continuing income interest allows for the establishment of a long-term cash flow strategy to the business owner, providing a level of protection for later years post-exit.

Yet another alternative strategy for accomplishing the business owner's charitable inclinations is through the use of a charitable foundation – specifically, a private family foundation. Properly structured, the family charitable foundation can receive the same gifts and contributions as any other charitable organization, albeit subject to lower deductibility thresholds. The necessity of operating the private family foundation in accordance with all of the applicable rules cannot be overstated. While these rules do impose a level of complexity and potential penalties not shared by the earlier charitable giving strategies, the benefits of using this mechanism to accomplish philanthropic objectives are many.

There are many variations on trust-related transactions and charitable organizations and foundations. Should the business owner have an interest in such transactions, gaining an understanding about his or her charitable aspirations will be paramount to building an exit plan that meets those goals.



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Summary

While these three broad avenues govern most business owner exits from existing businesses, the variations and nuances of any specific strategy are endless. Understanding all of the facts and circumstances is critical to the development of a successful exit planning strategy, and care must be taken to ensure that the long-term goals and objectives of the business owner are incorporated into the exit planning process. Lastly, as illustrated throughout the discussion in this chapter, the best time for consideration of exiting the business is as soon as possible. Starting earlier than what is deemed to be absolutely necessary is not as problematic as starting the process too late.



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Chapter II – *Understanding the Various Options for Exiting a Business*

As reiterated throughout these materials, exit planning is a complicated undertaking that encompasses an entire process, and no singular event within that process constitutes an exit plan. However, within the context of exit planning, no single event is likely more significant and more complex than the sale of the owner's business or equity ownership therein. In the overall scheme of exit planning, any plan that includes a sale of the business must have considered the many technical, quantitative and qualitative facets of each possible alternative transaction. While a number of these items have been addressed from the perspective of defining the objectives and the considerations that accompany those decisions, this chapter will focus on specific matters that demand advisor and business owner focus prior to moving forward. Vetting each of these alternatives to determine, as best one can, and to compare the advantages and disadvantages under each is an integral part of the exit planning process.

Sale of a Business – Basics

There is some danger in setting out a discussion intending to address the “basics” in a sale of a business, as every transaction differs in many aspects, including: dynamics between buyers and sellers, nuances and specific financial and operational attributes of the business under consideration, specific needs of both buyers and sellers, facts and circumstances surrounding the company, deal structures, financing capability and availability, and legal considerations. Because of these factors, among others, each business sale is different.

Structuring the Transaction

It is noteworthy that business acquisitions and divestitures can be accomplished in a taxable transaction, as is most often the case, or in a nontaxable transaction, such as in the course of a “stock for stock” exchange. The focus today is on taxable transactions.

Taxable transactions can be bifurcated further into two “sub” classes: asset sales and equity ownership interest sales. The primary difference between the two relates to the federal and state income tax implications associated with asset sales over an equity ownership sale. The matter is accorded even more complexity from an income tax standpoint depending upon the organization structure from which the company operates. For example, the tax treatment differs markedly whether there is a sale of assets from a company formed as a regular subchapter C corporation, an S corporation and a partnership, or a limited liability company.

Structuring the elements of a business sale transaction will heavily influence the tax implications of the transaction. Very often, deferred transaction receipts allow the transaction, and its corresponding gains, to be recognized



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under the installment method, thus spreading the tax liability forward to correspond with the payments by the buyer. Elements of the structure that are attributable to covenants not to compete, as well as consulting or advisory services agreements, are taxed to the recipient as ordinary income, thus eliminating any benefit of the preferential capital gains rates.

Finally, while direct sales of equity are generally the simplest deal structures and offer the business owner the lowest overall tax liability, all other things being equal, buyers most often wish to acquire assets, enabling them to write off the asset purchase price through depreciation deductions over time. The purchase of assets also, importantly, allows the buyer to be selective in assuming the liabilities of the selling business owner and, thereby, limit exposure in the future.

Sale transactions should be viewed as a generator of future cash flows to meet the exiting business owner's future needs. As discussed earlier, planning for the availability of assets, as well as income streams, is critical to the overall ability to satisfy expected future expenses so as to enable integrated planning from that perspective.

A sale of the business by the owner invokes concerns on many different fronts, which require careful advisor assessment prior to taking unchecked action steps. These concerns include valuation considerations, gift and estate tax considerations, investment considerations, income tax considerations and succession plan considerations.

While not always the case, a sale of the business can equate to an "all out" position for the selling business owner. In other words, it is critical that the business owner fully understands that the sale of his or her business is a one-off transaction and that he or she can do the deal only once. After that one time, there is no opportunity to go back to the table to renegotiate. It is also important that he or she understands that there is no going back for control. He or she will not be afforded the freedom and flexibility at the company that he or she enjoyed as the business owner. Thus, excepting any agreed-upon employment contract and deferred transaction proceeds, no further funds will be available through the company. Planning for this outcome generally has a profound effect on the accepted final transaction consideration and terms, as this is "the last drink from the well" for that particular business owner.

Determining Potential Buyers

The key question at this point in the exit planning process is whether the sale of the business remains a primary objective of the business owner. If so, then the next question is whether there is a preference for buyers. As noted in the last chapter, the primary choice is most often family members, especially those that have been successful and actively involved in the enterprise, thereby solving the business succession issue as well. In addition to family



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members, an employee, or a group of employees, very often can represent desired buyers. These groups generally include members of the management team.

After the two internal buyer pools, it is usually prudent to look to third-party buyers. Remembering that the business owner is stepping away, it is incumbent upon the advisor team to compare transaction consideration in a sale to family members or employees against the consideration that one might get from a third-party buyer. Oftentimes, the third-party buyer will pay an amount greater than the other two buyer groups based on an ability to bring strategic or synergistic advantages to the company after it is acquired. Assuming a taxable sale to all parties, it is only logical that a strategic sale to a third-party buyer will yield greater “net” proceeds to the selling business owner.

There are, as noted further in this chapter, means to accomplish a sale to employees in an ESOP, which can be structured to great tax advantage for the selling business owner. This tax differential must be buffered against the concept that the ESOP can purchase the equity shares for no more than fair market value.

The term “fair market value” is defined as “the price at which the subject property (business) would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.”

A buyer in the open market may be inclined to offer investment value or strategic value, which differs from fair market value. Investment or strategic value is the specific value of the business to a single particular purchaser. Under the fair market value standard of value, it is necessary to assume an entire universe of potential buyers, versus a particular buyer that might bring certain motivations to the purchase transaction and synergies to the business entity after the transaction. As a result, it is not uncommon that investment values or strategic values are often considerably higher than those values associated with the fair market value standard of value. Determination of investment or strategic value would require buyer-specific information, which may not be available. The buyer information would include the specific characteristics of the single buyer and a listing of the synergies that the buyer could bring to the transaction.

Alternative buyer pools provide a number of potential avenues for the business owner to explore in consideration of exiting the business. Some of the most common examples follow.



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Internal Buyer Options for the Business Owner

Sale or Transfer to Family Members

As noted in the previous chapter, family members actively involved in the privately-held business are most often the desired transferees of the business owner's equity ownership interest. This is especially true if those involved in the business are his or her own children. While this target transferee group was addressed in Chapter I, the focus in that section was more on the general nature of gifting ownership or entering into a mixed transaction comprised partially of gifting and partially of a sale. This chapter is intended to focus more on some of the challenges associated with a sale to family members.

The first, and perhaps, most important, question facing the business owner with this objective is whether those that have been involved in the business are, in fact, qualified to take over the business into the future. While the business owner is certainly concerned with the implications of developing an exit plan, there is no point in the process that more directly crosses over to business succession planning than through the sale of the entire business. There is no exception to that point, no matter the ultimate buyer. To dismiss the qualifications of the business owner's children to succeed him or her is to do them a great disservice.

In making the assessment from the perspective of both the advisors and the business owner, it is important to consider the children's years of experience; the business roles they have undertaken during their time with the company; their education and technical training; their experience in management; their knowledge of operations and financial matters; their relationship with non-family employees, customers and vendors; and their general business acumen. This process of properly vetting family members for business succession is likely the greatest reason that family-owned businesses do not extend beyond two generations, on average.

Clearly, if the family members are not qualified to succeed the business owner, a failure to consider this, and act on that finding, is probably going to significantly increase the chance for early business failure or diminishment of value built by the senior-generation business owner.

A second critical element of this exit planning objective concerns how any or, perhaps, all of the purchase price consideration will be paid to the senior-generation business owner. As addressed earlier, oftentimes, this type of intra-family sale is accomplished at less consideration than what might otherwise be attainable in an outside third-party sale. Adding to that negative aspect is the reality that the family members very likely do not have sufficient savings to acquire the business, once again forcing the business owner to finance the transaction. As noted earlier, this outcome results in the business owners paying themselves from future company free cash flows. This exposure is compounded further when lenders that are financing equipment and working capital through conventional business financing vehicles demand that the business owner's note receivable be subordinated to the lender debt.



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Another substantial drawback to undertaking a direct equity sale of the business to the business owner's children is the effect of income taxes. Assume that a junior-generation family member who has been working in the business purchases the senior-generation business owner's equity interest for fair market value. (Remember, fair market value is likely less than investment, strategic or synergistic value, so the business owner is already accepting less consideration.) The consideration is to be paid over time with a seller note from the business owner.

The tax burden associated with a sale of equity interests to family members can also be daunting. The cost of the business owner's equity interest is not deductible from taxable income. As a result, the purchasing family member must earn enough money to pay the income tax and, yet, net sufficient funds to pay service to the debt. The selling senior-generation business owner pays income tax on the interest received at ordinary income tax rates and on the capital gain on the sale of the equity interest at capital gains tax rates. The interest is, of course, deductible by the buyer. Lastly, when the senior-generation business owner dies, his or her heirs will possibly be required to pay the estate tax on the profit that he or she realized from the sale to the junior-generation family member.

There are, however, advantages to a sale to family members that, while perhaps not specifically quantifiable, may lead to greater business success in the second generation. First, the relationship of the business owner to the purchasing family members is likely to lead to a continuing involvement and, at a minimum, ongoing consultation from the selling owner for an extended period. Such ongoing involvement carries with it historical knowledge that will likely help second-generation owners avoid mistakes that another buyer might make.

In addition, customer relationships, vendor relationships and employee relationships are more likely to remain steady in an ownership change among family members, a seemingly natural transition. Such relationships are critical to ongoing operational efficiency and continuing the growth and profitability of the company after the sale.

Even with these advantages, the sale of a business, especially in its entirety, to junior-generation family members is a daunting exercise fraught with great risk to the selling business owner. If continuing operation of the business with junior-generation family members serving as management and owners is the business owner's objective, then the transfer of ownership can more easily and cost-effectively be accomplished in a manner other than a taxable sale.

Sale to Employees

It is not unusual that business owners would feel a strong emotional commitment to employees who might have contributed in a significant way to the success of the company. Rewarding these employees for that commitment is a major reason that this option has gained acceptance over time as a practical way to facilitate business owner transition or succession of the business, while still allowing that owner to obtain certain monetary consideration from the sale.



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Since the buying employees are usually key members of management, the issue of transferee qualifications and experience is less obtrusive than when selling the business to family members. These employees have often worked side-by-side with the business owner, so greater clarity as to management style and capability is almost always known by the time a decision has been made to sell the business to them. Moreover, historical relationships with customers, vendors and employees are all established when selling the business to management employees. Such an understanding can aid the business owner in attaining a level of comfort that the company will continue forward as it has in the past.

As is the case with the family-member scenario, it is likely that employees, including management, will lack sufficient resources to allow for a full cash payment at the closing of the transaction. They will likely have neither sufficient savings nor an ability to leverage the company to a degree necessary to meet the total date-of-closing consideration that the business owner might obtain from an outside third-party buyer. The management group may, however, have greater borrowing capacity than family members based on its history of capabilities to sustain future cash flows.

The primary issue associated with seller financing is always the risk about getting paid when the deferred payment period ends. Even securing a seller-financed sale to the management group with the stock that was transferred in the transaction does not begin to protect the business owner from substantial risk.

In conjunction with the option for a sale to employees, the tax implications are generally the same as those that were addressed under the sale to family members. Keep in mind that while this program does not involve in-depth discussion of the tax implications of various options for various tax entity structures, it is noteworthy that business owners appreciate that complex differences exist among possible transaction options and the form of entity with which the business owner is involved.

Employee Stock Ownership Plan (ESOP)

An ESOP will allow for a ready market wherein shares of the owner's stock can be sold without time delays and the economic risks associated with those delays. There are important considerations for owners considering adopting an ESOP relative to the value of their stock, tax treatment of proceeds and timing of their exits.

An ESOP is a type of qualified retirement plan established for the benefit of employees. As an exit planning strategy, business owners can sell their shares to an ESOP so that the transaction can be accomplished in a tax-deferred manner, often with "permanent" tax deferral and savings. Under Internal Revenue Code Section 1042, C corporation business owners who have held their stock for three years can use the proceeds from their stock



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sales to purchase qualified replacement property and defer their capital gains when this transaction is completed within 12 months of the stock sale. Owners of S corporations can also use ESOPs as a transition option or for shareholder liquidity, but they do not enjoy the same capital gains deferral benefits.

A business owner can sell a portion or all of his or her shares to an ESOP. By selling some portion of his or her ownership in the capital stock, the controlling shareholder/owner may be able to retain control while still diversifying his or her portfolio and spreading investment risk. The sale of stock to an ESOP must be at fair market value rather than at strategic or investment value. This is important for the business owner to understand prior to entering this type of transaction.

Transactions involving ESOPs can be leveraged, wherein the sponsor company borrows funds from a bank or other qualified lender to purchase the stock of the exiting owner. The company usually gives the lender a guarantee that it will make contributions to the employee stock ownership trust, which enables the trust to amortize the loan on schedule; or, if the lender prefers, the company may borrow directly and make a loan back to the ESOP.

From the perspective of the sponsoring company, the implementation of an ESOP can, and should, be viewed as an avenue of corporate finance. The authors of this material have observed the corporate finance features of ESOPs being used in many different capacities, including fresh equity capital raises, refinancing and debt restructurings, and asset acquisitions with external third-party lending institutions.

In addition, as the ESOP rules allow for funding annual contributions with stock, the plan can be used a means of generating additional operating cash flow. Finally, since qualified plan contributions are tax-deductible, use of an ESOP as a device to facilitate stock acquisitions with debt allows for the funding of both principal and interest on that acquisition debt with pre-tax dollars.

A very special incentive of ESOPs is the fact that dividends paid on ESOP stock are tax deductible if they are used to fund the repayment of debt principal that was borrowed for the purpose of acquiring the stock on which the dividends are being paid. In combination with pre-tax funding of debt principal and interest, tax-free dividends can lead to greater company cash flows than might be possible under other alternative strategies.

It is well-documented that employee ownership serves to increase employee morale, as well as employee productivity. Participation in an ESOP has also found to be a deterrent to employee turnover. One well-known study conducted by the National Center for Employee Ownership (NCEO) during the 1980s found that ESOP companies grew more than 5% faster than non-ESOP companies. These findings are confirmed by later studies and lead to the conclusion that employee ownership and participation in management result in faster-growing business enterprises.



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While ESOPs offer many special tax benefits, including potential capital gains deferral for C corporations, they also involve increased complexity related to adhering to rules and regulations on the part of the IRS, ERISA and Department of Labor, which can increase the initial and ongoing administrative costs of this type of exit strategy.

ESOPs are attractive to business owners who do not have family members to succeed them in the business. Although ESOP transactions carry many tax advantages for both the exiting owner and company, it may not be the answer in every case. In practice, ESOPs also face management succession, financing, and risk issues similar to management (or employee) buy-outs.

For a comprehensive overview of ESOPs as an exit planning strategy, please refer to our guide titled, [*Employee Stock Ownership Plans: Understanding ESOPs and Their Use in Exit Planning*](#), available on our [website](#).

Shareholder Buy-Sell Agreement

Owners of closely-held businesses may have a mechanism in place in the form of a buy-sell agreement, which speaks to an exit from the business based upon certain “triggering events.” The agreement should contain provisions that determine how an exiting owner’s shares are valued, the term of the buy-out, and how it will be funded. Too often, these items are not properly addressed, which can create consternation relating to transactions governed by the buy-sell agreement.

Because of the failure to address these issues, transactions entered into in connection with a buy-sell agreement often end up with parties disputing value, which is resolved through litigation. There can be additional risk to the exiting shareholder if the buy-out of his or her interest takes place over time, thus tying the departing party to the future performance of the business post-transaction.

Partial-Sale Transactions

One important advantage of consummating the business owner exit through an internal transaction is the ability to accomplish the sale through a series of transactions, versus a single transaction, as is often the case with external buyer options, which are discussed below. In most instances, it has been the authors’ experience that partial sales to family members, employees and/or an ESOP can turn the overall buy-out into a more-manageable transaction from a debt-payment point of view, and they allow the business owner to “stage” future sales according to company borrowing capacity, management capability improvement and “timed” management transitions, to allow for an orderly turnover of control and operational continuity. Each of these advantages provides a differing level of protection for the business owner, as he or she remains in control until the transition is more likely to be successful.



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In addition, depending on the “post-transaction” income needs of the business owner, there may be structural advantages on his or her end to provide income sources for satisfying these needs. By remaining in control, there may be an opportunity to continue non-transaction sources of income (such as compensation and bonuses), qualified plan contributions and, possibly, rental income. Monies paid to outside qualified plans may be structured to allow for the continuing build-up of the business owner’s after-tax savings, lessening the pressure to get more dollars from the later, staged business-equity-interest sales, if that objective aligns with the business owner’s desires.

External Buyer Options for the Business Owner

An Initial Public Offering (IPO)

While an IPO is an option, the journey and requirements are so onerous as to prevent it from being a viable consideration for most closely-held businesses. In an IPO, the owner sells a portion of the company in the public markets. Owners, and their management teams, typically remain in place for a period of years, investors and managers may be able to sell some stock, and the company continues to operate primarily as it had in the past. However, the company will be subject to additional regulations, such as Sarbanes-Oxley requirements, and stock analysts and institutional investors will scrutinize the company’s quarterly performance.

Only a very few small businesses actually have this option available to them since there are very few IPOs completed annually in the United States. Business owners need financial and accounting rigor from Day One far above what many entrepreneurs generally put in place. Additionally, some forms of corporations, like S corporations, require a reorganization before they can be taken public. Note that there are companies that have the scale and growth necessary for a public offering; however, the owners and management team simply do not want to deal with the rigors of being a public company.

Most investors do not favor an IPO as a viable exit strategy for current shareholders. Rather, they prefer to find companies that require the financial strength of public markets to grow the business and take advantage of market opportunities.

Third-Party Sale (Strategic Acquisition)

Business owners focused on achieving maximum value and liquidity typically seek strategic sales. In a strategic acquisition, another company purchases a business, either with cash or stock in the acquiring company, or a combination of both. A strategic sale can represent the shortest timeline to liquidity and departure from the business post-closing.



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Facing a buy-versus-build decision, many strategic buyers turn to acquisitions to rapidly gain market share and access to new markets, proprietary products and complementary brands. Opportunities for synergies, including increases in top-line revenue or expense reduction, enhance the post-closing value realized on the part of the strategic buyer, thus allowing them to pay higher prices relative to other types of buyers (including financial buyers). If there is a situation involving multiple buyers, a bidding war could escalate the price far above the owners' expectations.

While the benefits of full value and immediate liquidity can meet owners' objectives, selling shareholders must come to terms with certain trade-offs inherent in a strategic transaction. While the ownership change eliminates the risk to current owners from unfavorable future developments, either internal or external, selling shareholders relinquish control of the business and forego participation in the future upside of the business. Also, it cannot be understated, that during the sale process itself, the business can be exposed to a variety of risks, including competitive exposure, breaches of confidentiality, and management distraction. Confidentiality is always a challenge to maintain but, when a competitor is involved, the challenge is much more daunting. Lastly, acquisitions can be accompanied by contingencies and the execution of noncompetition agreements that may have owners tied to the business for a specified time.

Third-Party Sale (Financial Buyer)

Shareholders seeking partial liquidity often look to a partial sale to a financial buyer or private-equity sponsor. Financial buyers and private equity funds acquire minority and majority equity positions in operating companies, build the businesses by contributing strategic and operational experience, and then achieve liquidity in a future second sale, generally two to six years later. This relatively-long timeline often fits the needs of an owner, balancing the wish for near-term liquidity with the desire for participation in the future upside of the business.

Selling shareholder groups with divergent interests, such as founders, second-generation owners, and outside executives, can mix and match their transaction liquidity and equity rollover participation based on their personal situations and objectives. Management stays in place with a focus on growing the business, frequently through acquisitions and other new strategic initiatives.

Similar to other non-strategic alternatives, financial sponsor-led liquidity events generally rely on the use of leverage to finance a significant portion of the purchase price while offering few strategic synergies. Credit availability, required investor returns, and the lack of strategic synergies may limit the purchase price that financial buyers can pay. Having new institutional partners, such as a private equity investor and senior or mezzanine lenders, can create



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new financial reporting and operational requirements, from the board level down to day-to-day operating decisions. Additionally, new transaction-related debt creates default risk for post-closing shareholders, and debt service may become a stressful, unpleasant experience for management teams not accustomed to operating with leverage.

Liquidation

This is one option that is not very common due to unfavorable tax consequences in most instances; however on occasion, this option may be the best alternative. While nobody starts a business with a plan to liquidate it in the future, it can, and does happen, out of necessity.

At most, the proceeds in connection with liquidation would approximate the market value of the company's tangible assets. These assets primarily include inventory, receivables and fixed assets (including real estate and equipment). Intangible assets, such as customer lists/relationships, proprietary know-how and trade names, typically do not have value during the liquidation process.

One instance in which liquidation may be the best choice is when the underlying assets of the business have considerable value that is not really related to the core business. An example would be a struggling operating business with a long stretch of prime waterfront property, which is owned by the company. The land, in this example, is likely far more valuable than the operating company, which leads one to conclude that liquidation would be the best option.

Maintaining the Status Quo

Finally, the decision to maintain the status quo represents the default alternative for business owners. Shareholders retain total ownership of the company and maintain full control. This option introduces no incremental risk, and owners continue to benefit in the event that the company grows and prospers. The company finances expansion through internally-generated cash flow and additional bank borrowings in conjunction with the normal course of business. Should additional bank borrowings prove necessary to fund growth, a business owner's personal liability may increase as a result of the personal guarantees required by many lenders. Owners continue to enjoy the benefits (and risks) of the business.

The status quo offers very limited liquidity and wealth diversification, relegating wealth preservation and creation to ongoing business execution risk, perhaps at a time at which the owners are not performing at an optimal level. Furthermore, without the input from a strategic or financial partner, the owner continues to stay the course, potentially risking wealth by betting on favorable future operating results. Understand that maintaining the status quo may not address the liquidity needs of owners who develop unique interests and objectives over time.



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Summary

In closing, it is critical that business owners consider their options carefully, incorporating the assistance of experienced advisors. The biggest mistake that a business owner can make is to avoid engaging outside advisors in order to save transaction costs. Calculations should be undertaken for each applicable exit option that aligns with the desires and objectives of the business owner. Consideration should be given to the range of values attendant to privately-held businesses, the impact of taxes and fees in connection with the transaction, and the resulting cash flow to the owner. Proper planning and consideration of the various options summarized herein will ensure that the wealth transfer mechanism selected will accomplish the owner's goals. Then, and only then, can the owner move on to the next phase of his or her exit plan.

Note, also, that there are generally numerous courses of action beyond the traditional idea of simply selling the business in one of the ways noted above. As noted in Chapter I, gifting strategies, along with various charitable giving strategies, can get the business owner to the place that he or she needs to be without a traditional sale transaction. Additionally, there are any number of ways to join multiple exit strategies together to arrive at an end result intended by the business owner.



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Chapter III – *Exit Process: Identification of Steps & Who Should Be Involved*

Clearly, and as can be surmised from all of the information shared thus far, planning for a business owner's exit from a business requires a broad scope of professional capabilities, aligned in a team effort, that will allow for integrated disciplines to assist with the development and accomplishment of business owner objectives.

A well-defined and well-executed exit plan will involve numerous personal interviews and discussions with the business owner and, often, his or her spouse. These discussions will facilitate the preliminary definition of business owner objectives; substantial gathering of facts and background materials, as well as a detailed analytical review of these materials; team development of exit planning options available for the business owner; preparation of required analyses to discern propriety of the recommended options, including, if necessary, a determination of the value of the enterprise; presentation of the recommended options to the business owner; comprehensive drafting of all necessary documents to facilitate the different facets of the exit plan; and, finally, the development of a detailed plan to facilitate execution and implementation of the exit strategy, as well as controls and procedures to measure implementation.

At Grossman Yanak & Ford LLP, we also think the process should include a "post-execution" assessment wherein the final results are evaluated and compared, as well as communicated to the business owners, to allow for their understanding all that has occurred in the process. It also enables the business owners to evaluate how the exit plan, and process, has accomplished what was envisioned at the front of the process.

That being said, the authors view exit planning as a process, with multiple stakeholders, that can be broken into several general phases, each including specific steps and procedures, as detailed in the following sections.

General Phases of Exit Planning

Those general phases of the exit planning process, as delineated above, are those that we most often observe as constant from case-to-case and can be broadly captioned as set forth below.

1. Business owner meetings/interviews/discussions
2. Information gathering and document collection
3. Analysis and assessment of background information
4. Team communication to develop probable strategic recommendations
5. Preparation of the required analysis to confirm recommendations
6. Team communication to finalize recommendations



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7. Presentation of exit planning recommendations
8. Implementation
9. Follow-up and evaluation of the exit plan

As one would intuitively think, each of these nine phases consists of several steps that are common to the process. These phases are discussed in more detail in the next section of this chapter.

Business Owner Meetings/Interviews/Discussions

The business exit process generally begins with a meeting between the business owner and a key advisor. While we have emphasized the “team” concept involved in exit planning, and we think that the concept is critical to the overall success of the effort, the initial meeting generally occurs with only a trusted advisor who, very often, becomes the “quarterback” of the process. Who this trusted advisor is depends upon who has a close and trusting relationship with the business owner. Sometimes, this person may be the business owner’s attorney; other times, it is the outside accountant or financial planner.

Leveraging the expertise of various advisors bringing different perspectives to the table forms a solid foundation for an effective exit plan. Members of the team generally include an accountant, corporate and estate planning attorneys, a business valuator and a wealth manager. A critical aspect of the team concept is that not all parties can rise to the level of overseeing the process. Egos must be left at the door for the benefit of the business owner, and a spirit of cooperation must govern the entire process to avoid duplication of effort and to ensure the best possible result. Finally, there must be an understanding that members of the team may take on multiple roles in the process.

The initial meeting(s) is/are critical to identifying the wishes and objectives of the business owner and, often, his or her spouse. Understanding the objectives, without question, governs which other professionals will become part of the exit planning team. Keep in mind that while the overall objective is generally set at the initial meeting, objectives set at that point in time are fluid. As other members of the team join the analysis and assessment of the exit planning objectives, there are often evolutionary changes mandated by the parameters offered by differing professional perspectives.

Information Gathering and Document Collection

Once the initial meetings are complete, the exit planning team must work together to develop an approach, including necessary procedures to gather the important and critical facts attendant to the particular situation, as well as any and all historical documents and background materials deemed relevant to the project.



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Oftentimes, these procedures will begin with the provision of detailed information (including a questionnaire) and document requests to the business owner. The listing may contain any relevant documents that one might think of in conjunction with the business owner's finances, but it would not be unusual to look at other information. Such documents can include prior personal financial plans that might have been created by the business owner's financial advisors; business entity information, including historical income tax returns, financial statements and legal governing documents; personal income tax returns; estate planning documentation; as well as personal data and family information, financial and otherwise. Note that these lists can often be extensive, as a great amount of information will ultimately be utilized in conjunction with the exit planning process. Note also that the initial document/background information request is most likely only the first of several requests that will be required as advisors drive through the entire process.

One of the tools often used within exit planning assignments are questionnaires. While the information requested in such tools can vary widely, the following is an illustration of the type of information often sought in the course of such assignments:

- Personal information
- Contingency plan
- Company information
- Business description
- Company background
- Owners
- Industry data
- Markets and competition
- Operations
- Company products
- Sales, marketing and distribution
- Customers
- Suppliers
- Information technology
- Insurance
- Personnel
- Equipment, machinery and intangible assets
- Real estate
- Environmental matters
- Safety
- Opportunities for growth
- Inventory
- Strengths and weaknesses
- Price and terms
- Financial summary
- Taxes
- Contracts
- Litigation and regulatory compliance

Completing the Questionnaire

After the business owner receives, completes and returns the questionnaire, it will be necessary for the advisor to review the completed questionnaire. At that point at which the advisor has a thorough understanding of the business owner's company and personal affairs, it is likely that it will be necessary to meet with the business owner again, to refine the objectives and goals set at the initial exit planning meeting.



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Refinement of the Goals and Objectives

In the refinement step, there are three types of goals and/or objectives that must be addressed:

- Personal,
- Business, and
- Financial

As has been discussed throughout the course of this program, the importance of integrating a final strategy with meeting the objectives and goals of the business owner on these three levels is paramount to the success of the plan.

The goals and objectives of the business owner are his or her own. However, in setting goals and objectives, it is important and necessary to understand that they must meet certain evaluation criteria to be workable in any particular exit plan. The primary criteria by which the goals and objectives should be evaluated are as follows. The objectives should be:

- Measurable,
- Aspirational,
- Realistic/achievable, and
- Motivational

By considering the above characteristics in the goal-setting process, the business owner will be able to identify appropriate personal, business and financial goals. A business owner would be wise, however, to also consider various timing elements related to his or her goals and objectives that may affect action steps and expected outcomes, especially as they might relate to the valuation of the business.

By way of example, an owner's age, energy level, health, passion about the business, personal involvement in the business and willingness (or lack thereof) to remain associated with the business after exiting – all personal elements – will play a critical role in developing actions to be undertaken with respect to the exit strategy and in estimating the value of the business. Likewise, various business elements (such as the company's growth stage, historic trends and future prospects) and market elements (such as the health of the economy, the availability of debt/financing and the tax rates at the time of exit) will also influence the valuation of the business, as well as available exit options.

Personal choices for future lifestyle, as well as intentions to undertake alternative activities, including, perhaps, continuing employment in some fashion, will also contribute to the goals and objectives set throughout the process.



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Analysis and Assessment of Background Information

The analysis and assessment of background information is a critical element of the overall exit planning process, as it incorporates the input of all of the members of the advisor team and ultimately leads to the finalization of the goal- and objective-setting requirements of the process. The analysis incorporates both qualitative and quantitative assessment. This analysis leads the exit planning team to an understanding of the strengths, weaknesses, opportunities and threats relating to the business enterprise; the personal estate and financial position of the business owner; and the expected financial needs of the business owner, post-exit, as well as his or her (and his or her spouse's) physical characteristics, as those relate to age, health and life expectancies. At this step in the process, a business valuation is typically conducted.

Preparation of a Business Valuation

Business valuation is, perhaps, the most complex of all financial disciplines. In reality, business valuation is not a standalone professional discipline but, rather, an integration of accounting, tax, economics, finance and statistics, melded into an analytical assessment of specific-entity attributes. The proper understanding and application of the concepts and methodologies encompassed in these various disciplines are then combined with the analytical, procedural and theoretical concepts and methodologies required to conclude on the valuation of privately-held ownership equity interests. While a detailed discussion of the business valuation process is beyond the scope of this particular program, the key components of the business valuation process warrant brief attention.

Note that the list of past programs at the front of this handout includes a number of seminars associated with the business valuation process. The authors would be happy to discuss detailed questions with you at any time.

Purpose of the Valuation

Integral to every business valuation conclusion is the purpose of the valuation. Often, nuances to the business valuation process are predicated upon the purpose of the valuation, and failure by the valuator to consider these nuances can have a profound effect upon the conclusion. It is, without exception, critical to the value conclusion that the purpose be matched with the appropriate procedures to produce a correct result. The question of purpose is one of facts and circumstances. A few of the many purposes for which business valuations may be prepared include:

- Purchase or sale of a business
- Bankruptcy
- Buy/sell agreement disputes
- Charitable contributions of company stock or equity units
- Employee stock ownership plan (ESOP) stock purchases
- Estate or gift tax planning and compliance
- Marital dissolution/equitable distribution proceedings
- Minority shareholder challenges



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Standard of Value

It is not overly complex to understand a standard of value. Though labeled a ‘standard,’ it is nothing more than a definitional explanation of different, commonly-utilized types of value. The standards of value most-commonly encountered by business valuers and users of valuation reports are as follows:

- Fair market value – Fair market value (FMV) is defined in the U.S. Treasury Regs (20.2031-1(b)) and Rev. Rul. 59-60, 59-1 CB 237 as “the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. Court decisions frequently state in addition that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.”
- Investment value – Also referred to as synergistic or strategic value, investment value is generally defined as the specific value of an investment to a particular class of investors based on individual investment requirements.
- Intrinsic/fundamental value – Intrinsic value represents a specific analyst’s judgment of value based upon the perceived characteristics inherent in the specific investment.
- Fair value: state statutory value – In most states, fair value is the statutory standard utilized to resolve shareholder disputes for both dissenting shareholder and oppressed shareholder lawsuits and civil actions. Fair value, for these purposes, is generally defined, with respect to dissenter’s shares, as the value of the shares immediately before the effectuation of the corporate action to which the dissenter objects, excluding any appreciation or depreciation in anticipation of the corporate action unless exclusion would be inequitable.
- Fair value: financial reporting value – Issued by the Financial Accounting Standards Board (FASB), FASB Accounting Standards Codification 820, Fair Value Measurement, defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” Please note that fair value for financial reporting has no relationship whatsoever to fair value under state statutes.

Note that for exit planning purposes, fair market value and investment value will be the standards of value applied.

Premise of Value

The premise of value is an assumption regarding the most-likely set of transactional circumstances that may be applicable to the subject valuation. Premises of value include going-concern and liquidation. Often, valuation professionals work under the going-concern premise of value, meaning that the existing management of the subject



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company will remain into the future and will maintain the character and integrity of the company. A liquidation premise would provide the net amount that would be realized if the business terminated and the assets were sold piecemeal. Liquidation can be either 'orderly' or 'forced.'

Date of the Valuation

The date(s) on which the subject business will be valued is/are important because events and circumstances can arise that can cause value to vary materially from one date to another. The date of valuation influences the information available for the valuation. It is the perspective from which all analysis is performed.

Subject of the Valuation

Describing the specific equity interest(s) that is/are the subject of the valuation must be articulated to result in a meaningful conclusion. The interest(s) can include equity stock (common or preferred, voting or non-voting) of a C corporation or S corporation, partnership interests (including general and limited partners) and limited liability company (LLC) member interests. It must be known if the subject is a partial/fractional interest, as must also be known the relationship of the partial interest to the whole. This is a point at which the interest can be characterized as a controlling, non-controlling or minority interest, as well as a marketable or nonmarketable interest.

Valuation Approaches and Methodologies

The discipline of business valuation focuses primarily upon three broad approaches to value:

- The **income approach** attempts to value future economic benefit streams (typically, cash flow) in present-value dollars at the date of valuation.
- The **market approach** requires the valuator to identify transactions that have occurred in the market that involve 'target' companies, as well as publicly-traded companies, that are sufficiently similar to the subject company to afford some indication of value, generally through the use of various valuation multiples.
- The **cost/asset approach** requires the valuator to determine the cost to construct or develop an asset, less any downward adjustment for obsolescence.

Within these broad approaches are numerous methodologies that require a variety of inputs and analysis – many of which are subject to the professional judgment of the business valuator. The various approaches and specific methods contained in each conceptual category may be classified as shown on the following page.



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Income

Capitalized returns

- Capitalization of earnings
- Capitalization of net cash flow
- Capitalization of gross cash flow

Discounted future returns

- Discounted net cash flow
- Discounted future earnings

Market

Value multiples using comparative company data or transactions

- Price/earnings
- Price/dividends
- Price/gross cash flow
- Price/book value
- Price/revenues
- Price/net asset value

Cost/Asset

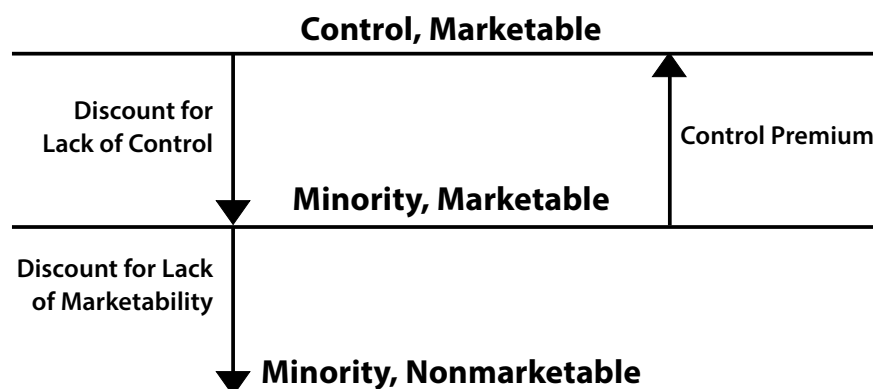
Underlying assets

- Net asset value
- Liquidation value
- Excess earnings
- Rules of thumb
- Sellers' discretionary cash flow
- Company-specific methods

Other

Levels of Value

Implicit to determining the propriety of premiums and discounts is an understanding of levels of value. Such levels are usually defined by the attributes of control and marketability. From a risk perspective, owning an equity interest that allows the holder all perquisites of control over entity operations is more valuable than an identical interest that does not allow for control. The attribute of marketability adds value by lowering risk, while a lack of marketability does the opposite. Historically, the business valuation and finance communities have assumed three basic levels of value, which are presented in the following graphic.





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Please note that the mechanics of applying discounts in a multiplicative fashion (as opposed to an additive method) results in the sum of the discounts for lack of control and lack of marketability producing an overall lower discount than adding the two raw numbers.

Valuation Synthesis

After all relevant valuation factors have been analyzed, they will be brought together to produce a final indication of value. There are circumstances in which a single approach or method should be relied upon, and there are other instances in which two or more approaches may result in such similar indications of value that it is not mathematically significant as to the amount of weight that is accorded to each indication. However, in instances in which the application of different valuation approaches and methods results in indications of value that are materially different, the indications should be reconciled into a single estimate.

Team Communication to Develop Probable Strategic Recommendations

At this point in the exit planning process, team members who have completed their analyses and assessments of the company and the background information will come together with recommendations to move the exit planning process forward. It should be noted that it is important throughout the process that all advisors maintain an open line of communication, thereby ensuring that work and procedures are not being duplicated and, more importantly, that the procedures and analysis that they are undertaking will result in recommendations and strategies that do not run afoul of limitations identified by other members of the exit planning team.

It is also important to understand that the process is fluid, as are the business owner's goals and objectives. Thus, as barriers arise due to technical or financial limitations, all team members must be aware of those issues in order to pose fresh planning ideas and strategies that, in the alternative, can overcome the barriers.

In those very few circumstances in which obstacles cannot be overcome, the business owner's goals and objectives may require further refinement prior to finalization to bridge the gap created by the identified barrier. Oftentimes, slight variations in strategies will work to ameliorate difficulties encountered with the earlier goals and objectives. This occurrence is not uncommon, as the business owner's goals and objectives cannot be finalized until each member of the advisor team has an opportunity to impart the results of his or her analysis.

Preparation of the Required Analysis to Confirm Recommendations

Confirmation of recommendations is predicated upon any, and all, final analysis by appropriate team members. It has been the author's experience that such final analysis may incorporate detailed tax calculations setting



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out the federal and state tax implications of any adopted strategy/recommendation. In addition, if a calculation of value (versus a full business valuation) was utilized in the earlier stage, it may be necessary to prepare a “qualified” appraisal or valuation for Internal Revenue Service purposes or for the Department of Labor (applicable to ESOPs). Financial planning specialists might, at this point, wish to tweak future expected income streams based upon final valuation numbers and expected future returns, assuming that net principal available for future investment varies as a result of differing strategies and values. It is also likely that legal counsel will wish to provide input and review various analyses that will likely influence the document drafting exercise.

Team Communication to Finalize Recommendations

This meeting or assembly of the exit planning team is, perhaps, the most critical part of the entire process, as it is here that the final exit planning strategies and recommendations will be developed. While there may be some need to reconsider aspects of the plan as implementation unfolds, the outcome from this meeting should be a solid plan containing the applicable action steps required of each member of the team, including target dates. This detailed plan will provide the business owner with a “roadmap” of the recommendations, implementation steps and timeframes and, most importantly, details about exactly how the implementation of that plan accomplishes the final goals and objectives set by the business owner earlier in the process.

A meeting of this sort, involving the entire exit planning team, would normally result in a “formalized” plan, recorded in a memorandum or a recommendations report that could be used by all parties involved in the planning and implementation. This memorialization will also serve as a control mechanism to ensure that all proper steps are, in fact, completed as directed in the document.

Presentation of Exit Planning Recommendations

An important part of this portion of the engagement will be to communicate the information finalized to this point to the business owner so that there is total accord among the business owner and the recommendations of the advisor team. It is most important, as noted earlier, that any final recommendations be understandable to the business owner, and it should be clear how the recommendations assist with the accomplishment of the business owner’s goals and objectives.

Once the business owner has accepted and agreed to the recommendations, all that remains is to facilitate the recommendations.



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Implementation

Perhaps the most important step in the process, implementation is required to validate all of the analysis and planning undertaken to this point. It is inherently important that implementation be viewed as the portion of the undertaking that forces the actual movement of the business owner's equity interest(s) to the intended recipient, thereby, allowing for a smooth exit. All other implementation procedures build around this transfer of equity.

Obviously, if the business owner should agree to the recommendation that the business be sold in a conventional transaction, it is a long-term implementation period. The time that it takes to sell a privately-held business enterprise varies but, generally, one can expect that the sale of his or her business could take several months, at best, to well over a year, at worst. In addition to company-specific risks and industry challenges, economic and open-market conditions can play a large role in the timing of a sale of a privately-held business.

The time period for full implementation of an exit plan will vary widely, given the many diverse fact patterns one is apt to encounter. For example, an exit plan invoking an annual gift of 10% of the business owner's equity interest would take 10 years to complete a clear and total exit. Alternatively, a sale of the business to competitors who have previously expressed an interest in acquiring the business could take as little as just a few months.

Implementation also includes finalization of valuation work; all legal work, including the drafting of any and all legal documents required to govern the exit planning steps; and tax calculations necessary to not only determine final tax liabilities, but also to plan for future cash flow needs to fund taxes. Implementation will also include preparation of any and all tax returns required by the recommendations.

The key element to implementation is control over the process. Advisors must keep control mechanisms in place to ensure that all steps and procedures are completed, and that they are completed in the manner necessary to facilitate accomplishment of the business owner's goals and objectives.

Follow-up and Evaluation of the Exit Plan

No strategy, for any purpose, can be properly evaluated with respect to its ultimate success until implementation is complete and the steps undertaken are operational and/or complete. Exit planning is no exception. Preparation of the memorandum finalizing the advisor team's recommendations provides a vehicle for comparison to actual performance results after the exit plan is placed into action.

Effective monitoring to longer-term exit planning strategies is also an important part of the follow-up. All professionals have observed business owners in receipt of strong planning ideas that have failed to yield appropri-



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ate benefit levels because of poor implementation or a failure to implement at all. For example, where charitable remainder trusts are used as a part of the exit planning strategy, continued monitoring to ensure compliance with organization documents and the overall exit plan recommendations is critical to ensuring a successful outcome. Another, even more-complex example might include a valuation enhancement process, whereby the business owner is deferring the sale of a business until a later date to allow time for improving the value of the business. Regularly measuring this value change is, again, a key component of a successful plan.

Generally, the authors think it best that exit plan evaluation be permanently documented in a formal communication to the business owner. This approach allows for total closure of the process and brings all the planning encompassed in the exit planning process full circle. It also provides the business owner with an appreciation of all that has been accomplished through this exercise.

Summary

Exit planning is, as noted throughout these materials, a multi-discipline undertaking with a wide breadth of issues and challenges. To address each case in the best manner possible, it is necessary to customize the exit planning process to each individual business owner's needs and wishes. As such, it must be remembered that the steps listed herein are those general steps, that the authors undertake and have observed in the past, that have worked well in our practice. It is not the absolute for every situation, and practitioners in the legal community will observe that exit planning teams will vary the process according to their experience and historical practices, as well as for specific business owner circumstances.



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Chapter IV – *A Brief Illustration of Exit Planning*

The following illustrations reflect three actual cases that we have worked on in our Firm over the last several years. While facts can vary widely, as discussed throughout this program, we note that there are several common key facts present in all three cases.

First, the clients that we assisted in these matters were all business owners. Two held majority equity ownership positions in their companies, along with several minority equity ownership positions held by a combination of family members and/or key employees. One of the cases involved a sole equity owner with no other owners.

Second, in each of these cases, the businesses were operating businesses with a long history of sustained performance, leading to an ability to accurately establish future operating performance. While each of the companies was evaluated against the industry norms in measuring performance and estimating value, the level of performance against the industry differed in each. In fact, one company exceeded industry performance, one met that level of performance, and the third underperformed its industry competitors.

Third, and finally, all three cases involved controlling equity owners that were over the age of 60 and interested in divesting themselves of the business ownership interests in the companies.

The balance of the facts and circumstances varied case by case. The point of the illustrations is to try and bring home some of the actual battlefield history associated with these three cases so that session participants can better understand the role of the attorney and other team members in this process.

Case Illustration 1

Case 1 concerns a wholly-owned manufacturing business located north of Pittsburgh. 100% of the stock was owned by a single individual. He came to us with the desire to, first, determine the value of his business and, second, discuss ways in which he might be able to successfully exit the business.

The business owner was over the age of 70 and had been able to turn over day-to-day operations to several key employees to whom he felt a deep sense of gratitude. He had not started the company himself, but he had worked there for many years, ultimately getting the opportunity to acquire ownership from the previous owner. Understanding the many ways in which that opportunity had improved his life, he was looking for the means to transfer the business, in exchange for monetary consideration, to the key employees. He had no children in the business.

In evaluating alternatives for this owner to leave the business, it was determined that the employee group did not have the economic wherewithal to borrow 50% of the total purchase price, an artificial threshold he set for himself.



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In conjunction with the exit planning, we evaluated the opportunity to move fewer equity ownership units to management, possibly invoking Internal Revenue Code section 83, Property transferred in connection with performance of services, hoping to generate sufficient tax deductions to produce tax savings that could offset some of the valuation considerations associated with a sale to management. These considerations included a lower standard of value (fair market value), than the investment standard of value. Thus, total initial consideration was significantly less than might have otherwise been attained from a third-party sale, especially if the business owner were to locate a strategic buyer. In addition, the business owner did not feel the need to have the cash value of the entire business enterprise, as that would have invoked estate tax issues, and he found that those funds were not required to meet future financial needs.

This determination was made in conjunction with development of a long-term investment strategy with the business owner's investment advisor. The strategy was predicated on differing levels of principal investment resulting from alternative business equity ownership sale scenarios. This exercise allowed the business owner, and his spouse, to gain a level of comfort that their future needs would be met at various levels of proceeds arising from different options.

The resultant "exit plan" included a compensatory bonus of approximately 20% of the company equity, leaving the business owner in control. Cash bonuses were paid to the recipient employees to pay income tax on the fair market value of the equity interests on a non-control, nonmarketable basis. The company received offsetting tax compensation deductions for both the fair market value of the stock recognized as income by the employees and the cash bonuses. Thus, corporate pass-through income was reduced by the amounts included in the income of the employees.

The valuation was such that removing 20% of the business owner's equity ownership allowed for greater cooperation from lenders at a later point in time (approximately two years). Further, it enabled the remaining 80% to be purchased by the company with a partial borrowing that allowed for half of the remaining interest to be paid at closing (on a control, marketable value). This down payment also included a substantial amount of cash accumulated by the company. The business owner financed the balance with a 10-year subordinated note.

Currently, the business owner note is up-to-date (through year six), and he has been traveling extensively, while also funding the education of seven grandchildren.

This team effort included input from legal counsel for operating agreement modification, buy-sell agreement work, employment work and estate planning issues; a valuation advisor; an investment advisor; a tax accountant; and a cooperative lending team. Note that the purchasing employees also engaged their own legal counsel.



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In the end, this business owner attained the desired objective of keeping the business operating in its historical fashion under the leadership of those employees who, he felt, had given the most to the company over many years. In addition, the company has increased the number of jobs since the acquisition by nearly 20%.

Case Illustration 2

The company in this case is a Washington County distributor of industrial products. The company was founded in 1960 by a single individual who ultimately brought his two sons into the business. The sons later brought in their two respective sons (one each). Thus, stock ownership was divided among four shareholders, two from the senior generation and two from the junior generation. Over time, through a series of transactions, certain stock ownership was repurchased by the company so that the company was left with a single shareholder group of one father and his son. The father owns a substantial majority interest, and the son owns approximately 10%.

The father, described herein as the majority business owner, desired to move the ownership to the son in the most efficient means possible. Based on a careful assessment of future lifestyle needs, as well as currently-projected assets and income streams to meet these needs, it was clear that he would not require the entire value of his ownership interest in the operating company in sale proceeds to meet these needs. The only additional concern for this business owner was to ensure that his second child, who is not involved in the business, be treated comparatively in the receipt of value from his estate.

This exit plan was structured under the leadership of an attorney specializing in estate planning, who designed a five-year gifting strategy to move a substantial amount of the equity through gifts of fractional non-controlling, nonmarketable blocks of stock (highly discounted). When the gifting is complete, the business owner's capital stock ownership will decrease to just under 30%. At that time, the majority business owner's personal financial situation will be reevaluated and adjusted, if necessary. It is expected that the value of the company at that point, along with other accumulated assets, will provide sufficient value to balance the amount of his net worth that will inure to the second child at his death.

The exit planning team included the estate attorney, a corporate attorney, an investment advisor, a tax accountant and a valuation advisor.

The facilitation of the gifting strategy allowed for the efficient transfer of value associated with the company, thereby accomplishing the business owner's objective of having his son continue the business without being unduly burdened by the debt service that would have resulted if the entire interest had been reacquired. In addition, as the transfers are staged over time, the business owner will remain in control for several years after adoption of the plan, thereby allowing for further accumulation of personal assets.



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Case Illustration 3

The third example case study involves a business owner that was, during his lifetime, a great philanthropist and a wholly-owned-business owner. He and his wife had maintained a very conservative lifestyle, in spite of his success, and managed to give away nearly \$8M prior to his death. Though they had four children, their intent in entering into an exit plan was to formulate an approach that would enable them to help each child (all grown and well into their careers, none with the business) by giving them each \$1M.

In conducting a valuation at fair market value, it was determined that the business was worth approximately \$24.8M. As a result of the business owner's objectives, it was decided that the company would be sold but that, prior to the sale, steps would be taken to arrange the equity ownership in such a manner as to allow for accomplishment of his (and his wife's) goals.

The primary element of the exit plan was designed to move certain numbers of owner equity units to a charitable foundation, allowing for future guidance of the monies therein to charitable organizations selected by the business owner and his spouse. The transferred shares were gifted with the knowledge that the company was in play. The transfers were ultimately made, prior to the sale of the company. The business owner obtained a material charitable tax deduction for these shares, though he did encounter a limiting charitable deduction threshold, requiring that the deduction be taken over several tax years.

Another block of shares was transferred to a charitable remainder trust directed at a separate "favorite" charity wherein the business owner retained an income interest over his lifetime. This income interest was designed to facilitate future income and cash to be used in meeting expected lifestyle expenses. The income estimates were provided by an investment advisor who developed a conservative portfolio mix. Associated shares were contributed to the trust, and a second charitable tax deduction was accorded to the business owner for the present value of the remainder interest, calculated in accordance with Internal Revenue Code rules.

Finally, the strategy included a lifetime gift of equity units to each of the business owner's four children. Certain gift taxes were paid, but the value of the shares had been determined on a non-controlling, nonmarketable basis, thereby diminishing the values at transfer and minimizing the gift tax.

Note, that the business owner did retain a small, non-controlling equity interest intended to supplement his other accumulated assets when the business was sold.

The amount of the discount for lack of marketability was nominal due to the ongoing discussions with the outside third-party buyer.



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The buyer in this transaction was a strategic buyer who was supportive of the seller's objectives and worked to see that each of the new equity owners was integrated into the transaction documents in a smooth and efficient manner. This made the professional endeavors associated with the transaction much easier.

The team that worked this strategy included an investment banker, an attorney knowledgeable of charitable planning, a corporate attorney, a tax accountant, a valuation consultant, an investment advisor, representatives from several charitable organizations, and numerous individuals inside the business owner's company who continued on with the buyer post-transaction.

This strategy worked to not only significantly decrease the gain on the sale of the business, but also provide a cash flow generation opportunity for the business owner through the charitable tax deductions. The income stream originally envisioned in the plan continues to provide annual cash flows to this couple, allowing them to pursue further charitable interests.

NOTE: The aforementioned examples are not substantially complete in these materials. There are far more complexities to each than was detailed herein. However, they are intended to provide a flavor of the strategic alternatives that might be available to the business owner, depending on all of the facts and circumstances, as well as his or her objectives. Technical assistance runs deep in the development of these strategies, and a team approach is always beneficial in the process.

The previous chapter of these materials has addressed the overall process generally envisioned in the conduct of exit planning assignments. As these examples illustrate, there is one thing that is certain and unequivocal – each assignment will vary widely due to the many tax, economic, legal and personal dynamics and nuances associated with specific fact patterns!



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Conclusion and Practical Observations

As has been demonstrated throughout the course of today's program, assisting privately-held business owners exit their companies and dispose of their entire equity positions poses a significant number of issues and challenges to both the business owner and the members of his or her advisory team. Many of those issues and challenges relate to the business owner's attempts to solidify the goals and objectives of any strategy that might ultimately become part of the final plan. Without question, exit planning for a long-term business owner presents real psychological and emotional dynamics that can affect the entire process, as well as the results. In addition, ongoing consideration of future life events expected to occur after the exit process is completed, as well as the costs associated with those events, must be a central focus of the business owner.

The issues and challenges associated with the various procedural steps, methodologies and implementation can generate significant economic, tax and financial issues. Moreover, many more qualitative challenges add to the problems facing the advisor team. Understanding the many facets of technical complexity offered by the various alternatives and planning options requires a broad base of education and experience. Most often, this necessary expertise will require a team approach, including participation by accountants, attorneys, wealth advisors and, possibly, financial advisors.

As with any team, teamwork leads to success. The team leader in each situation varies but, often, he or she is the advisor with whom the business owner maintains the closest relationship. On one occasion, this may be the accountant or CPA, while, in another case, it could be the attorney or wealth advisor. In each case, it is important to assume the role that is driven by the specific situation and work towards accomplishing the business owner's goals and objectives.

It is also important that those professionals working to assist the business owner with his or her exit planning appreciate the length of time required to fully implement and facilitate the plan. Working on a more-complex case in which the transfer of ownership is staged over several years can easily result in plans that require five years or more for full impact and closure.

The key to understanding the time requirement for the full realization of the impact of the exit plan brings home an obvious point – exit planning is a process that should be considered well in advance of the actual event. The more time that is available to take action can, and will, in most circumstances, lead to a better result for the business owner. Starting the process earlier will provide the business owner a longer period of time to think through the general implications of his or her exit. It will also allow for a longer period of time to accumulate assets, enter into gifting programs and, if deemed appropriate, continue to build the company and to reduce areas of risk with the company to improve value.



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The polar opposite of entering into an exit planning process is to allow the business to simply sputter at the death of the business owner. Most likely, if that business owner lives to his or her actuarial expectation, he or she will not have been able to run the business as effectively as when he or she was younger. As a result, such a strategy (or the lack thereof) will likely have already diminished the value of the enterprise at that point in time. This startling reality often serves as the catalyst for moving forward with exit planning, even for the most stubborn and hard-nosed business owner.

To neglect to plan for an exit is simply, and clearly, an unnecessary waste of the business owner's financial accomplishments. It is akin to throwing money out the window. Luckily, most business owners realize this and wish to preserve the wealth and assets that they have accumulated over their lives.

The professionals of Grossman Yanak & Ford LLP participates regularly on exit planning teams and, in this endeavor, partner with our friends in the legal community. While we have observed exit planning teams with a number of advisors representing various technical disciplines, we have also observed multiple roles assumed by a single team member. For example, we have noted on numerous occasions, attorneys in quality firms who have the capability to handle the issues attendant to a wide variety of legal matters, from corporate sale transaction representation to estate planning. Our professionals often serve as the financial planning resources and tax accountants, in addition to serving as valuation consultants, on different exit planning assignments.

The program today has included a great deal of information. We did not expect that those attending would immediately become exit planning specialists. However, we hope that we have conveyed the fact that a lot of what has been "repackaged" into an exit planning wrapper constitutes services that are already within your individual, and your firm's, capabilities. We can provide services to complement those that you offer to your clients. Should you find a situation in which you think that these types of services will be useful, please do not hesitate to contact Bob Grossman at 412.338.9304 or grossman@gyf.com, or Melissa Bizyak at 412.338.9314 or bizyak@gyf.com.

We would like to once again thank you for all that you do to help our firm. It is a pleasure for us to have the opportunity to speak to you, and we appreciate that you would take time from your busy schedule to attend our program. It is our hope, as always, that we will have shared some information that will be of help to you as you return to your own practices and interact with your clients.

Have a great day!



Grossman Yanak & Ford LLP

Headquartered in Pittsburgh, Grossman Yanak & Ford LLP is a regional certified public accounting and consulting firm that provides assurance and advisory, tax planning and compliance, business valuation, ERP solutions and consulting services. Led by six partners, the 25-year-old firm employs approximately 55 personnel who serve corporate and not-for-profit entities.

Our firm was founded on the idea that the key to successful, proactive business assistance is a commitment to a high level of service. The partners at Grossman Yanak & Ford LLP believe that quality service is driven by considerable involvement of seasoned professionals on a continuing basis. Today's complex and dynamic business environment requires that each client receive the services of a skilled professional with a broad range of experience and knowledge who can be called upon to provide efficient, effective assistance.

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