

Partner's Perspective

A Case Study: Why Succession Planning Is Important

By Cindy S. Johnson, CPA, CIT, Partner



John, the owner and founder of a successful manufacturing firm, is about ready to sell his company and reap the rewards of a lifetime of hard work: a comfortable, financially secure retirement with his wife in their cabin in the Catskill Mountains.

There's just one problem. John doesn't know how he'll exit the business. He always thought that one of his two sons, who have been working in the business with him for years, would eventually take over when he was ready to retire.

But lately, it has become clear that this isn't going to happen. His oldest son has lost interest in the business and has begun searching for a new career, and his youngest son simply doesn't have the desire or skills to run the company. As a result, since John has decided he doesn't want to retain the business without family involvement in management, his options are to sell the company to an inside group of management employees who have expressed interest in buying the business from him, or sell it to an outside buyer.

Factors to Consider

Whether selling the business or transferring it to family members, there are a number of factors John should consider as he looks at his options:

What are his objectives? The answer to this question will lay the groundwork for all the decisions John must make. For example, if his primary goal is to get the most money possible in order to maximize his retirement income,

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this could make it difficult to sell to insiders, who may require more flexibility in the price and payment terms.

Conversely, if successful continuation of the business as a legacy and ongoing security and contentment of his employees are most important to John, he might be willing to accept less money and longer (perhaps riskier) payment terms from insiders in order to make the sale to them possible.

How strong is the existing management team? Obviously, this would be a

- **Private equity investor:** These may be venture capitalists or “angel” investors whose goal is to invest money into and grow the business in order to sell it at a profit later. Such investors are generally in search of companies with strong management teams in place and clear growth opportunities.

A business broker or mergers and acquisitions consultant can help John gauge the potential demand for his business and serve as a go-between with interested parties.

Is he willing to assume any kind of post-sale role in the business? It’s not uncommon for buyers to expect the owner to stay on board for a period

The process of succession planning is crucial in helping ensure that owners reap rewards from the years of hard work they put into growing their companies.

key consideration if selling to insiders, because John must have confidence in their ability to run the company after he’s gone. But outside buyers will likely have a keen interest in the strength of management as well.

It’s important to note the difference between management succession and ownership succession. John should identify and train a strong successor management team as soon as possible, as well as prepare to transition his key business relationships (with customers, vendors, suppliers, etc.) to the successor owners. A buy-sell agreement should be a key part of the ownership succession process.

How much demand is there in the marketplace? John should begin gauging the potential demand for his business among the three primary types of outside buyers:

- **Complementary buyer:** This would be another business in a niche or industry that complements John’s business. Candidates would be companies that could strengthen themselves and/or open new doors of opportunity by adding John’s company.
- **Strategic buyer:** This would likely be a competitor that can bring enhancements to John’s company’s products and services by merging, and thus strengthening both operations. John must be very careful with this strategy; cultural clashes are one of the biggest causes of failure for business mergers.

of time after the sale to help ensure a smooth transition. John could do this as a paid employee, consultant or board member. This arrangement can be negotiated as part of the sale terms.

What are John’s liquidity needs? These will help dictate how the purchase is financed. Since John will use proceeds of the sale to finance his lifestyle during retirement, he needs to ensure a consistent stream of income for the rest of his life. If he collects the entire purchase price at closing, he can deposit or invest it and then make regular monthly withdrawals to meet his living expenses.

If he agrees to finance the purchase himself through a structured buyout, he could structure the payout to assure similar regular monthly payments. The benefit is that he could charge interest on outstanding amounts. The drawback, however, is that John is assuming some risk if the business fails before he has received the entire purchase price.



If John doesn't need the liquidity for retirement income, considering an employee stock ownership plan (ESOP) transaction might allow him the opportunity to defer income tax on the gain on his sale transaction.

What is the business's value? John should have a formal business valuation conducted by an unbiased, outside professional to establish a baseline from which price negotiations can begin. There are a number of things he can still do to position the company most favorably for sale and maximize the potential price, such as paying down excessive debt, filling key open positions, making sure all legal documents and contracts are current, and documenting the business's financial controls.

Start Planning Now

The process of succession planning is crucial in helping ensure that owners reap rewards from the years of hard work they put into growing their companies.

Don't end up in a situation like John's — ready to exit your business and retire, but without a plan in place to make it happen. Had he started the process earlier, there's a chance he could have successfully groomed one of his sons as a successor.

Start thinking right now about your exit strategy and begin laying the foundation for a solid succession plan that will meet your objectives and ensure the successful continuation of your business.

Please call or email me at cjohnson@bobermarkey.com for help in creating a succession plan and devising exit strategies for your company. ■

Reducing Taxes on the Sale

There are myriad and complicated tax issues involved in selling a business, so our hypothetical business owner John should work closely with his accounting professional to implement tax reduction strategies. Together, they should establish and implement legal and tax structures at least one year prior to selling to help reduce John's potential tax liability. Here are two thoughts to consider:

- In general, sellers can reduce their tax liability by structuring the sale of their business as a stock transaction. Buyers, however, generally prefer to purchase the assets of the business in order to benefit from immediate write-offs. This will likely be a key point of negotiation between John and any potential buyer.
- If John is going to finance the purchase himself, he can defer some of the taxable income and help cushion the tax hit by extending the terms over several years. However, this must be balanced with his liquidity needs and the additional risk he might be assuming. ■

Your Fixed Assets Can Generate Cash For You

For Capital Good Purchases, Favorable Tax Treatment Set to Expire

From the tax perspective, now is a good time to purchase capital goods thanks to the availability of the 50 percent bonus first-year depreciation. However, these tax breaks are set to expire after 2009 unless Congress extends them. Businesses may be able to lock in accelerated deductions by buying qualifying assets this year and placing them in service before 2009 year end.

For example, if a taxpayer buys a \$10,000 machine depreciated over five years for tax purposes, the taxpayer would be able to depreciate \$6,000 in the first year if placed in service by December 31, 2009. However, if bonus depreciation is not extended, then the taxpayer will only qualify for a \$2,000 first-year deduction in 2010. The generous bonus depreciation rule similarly applies to first-year limits on luxury automobiles.

Tax Savings through Fixed Assets

If interested in maximizing depreciation deductions, BMF performs several types of studies that optimize fixed asset deductions. These studies drastically improve cash flow by accelerating tax depreciation deductions. While BMF performs traditional cost segregation studies, we are the only firm with *Fixed Asset Express*. This powerful, internally developed software analyzes property and equipment registers, identifies tax-saving opportunities and automatically quantifies benefits.

The Opportunity

A fixed asset review evaluates all of a company's fixed assets and identifies those qualifying for shorter depreciable lives, such as:

- Land improvements, such as storage sheds misclassified as buildings
- Specialized plumbing or electrical used in process-related activities
- Furniture, countertops and kitchen equipment
- HVAC equipment used for cooling computer equipment or perishables
- Software misclassified as computer equipment

Moreover, since bonus depreciation is applicable to certain assets with tax lives of less than 20 years, there is an added incentive to identify assets originally depreciated as buildings qualifying for shorter depreciable lives.



By Alex Bagne, JD, MBA, CPA,
Senior Tax Manager

Not only do we search for assets qualifying for shorter depreciable lives, we identify expenditures that can be immediately expensed, such as:

- Roofing and parking lot repairs
- Carpet replacement
- Repainting
- Equipment and building maintenance
- Repairs due to severe weather or accident

Our Process

With the power of *Fixed Asset Express*, BMF can provide a preliminary analysis at no cost to our clients. By providing a simple download of your fixed asset register, we can input your assets into our system and quantify the benefits within as little as one day. BMF delivers turnkey solutions or we can utilize your employees to reduce costs. We also deliver highly detailed project summaries that support our positions if a project ever receives IRS scrutiny.

If you would like to explore how your business may optimize its tax position through an assessment of its fixed assets, please call or email me at abagne@bobermarkey.com. ■

Profile of an Occupational Fraudster



By Steven C. Swann, CFA, CFF, CFE, Manager

During tough economic times, the risk of fraud in business always rises. When employers cut back, employees may suffer reduced wages, lost jobs and increased financial pressures all around.

The risk of occupational fraud is typically highest among employees who either make payments to suppliers or receive payments from customers via cash or checks. Businesses cutting back in accounting staffing often have to reduce oversight of these vital functions, which increases the opportunity for potential fraud. Employees with the following profiles typically present the greatest risk:

- **Those with too much control.** Employees who can approve invoices for payment, cut and sign checks and prepare bank reconciliations can easily divert business funds for their personal use. Often, small businesses don't have enough staff to adequately segregate these duties, and this is when oversight must be heightened. Knowing someone is looking over their shoulder greatly reduces employees' willingness to commit fraud.
- **Those whose personal financial situation has changed.** Employees who have suffered a recent personal setback — such as a spouse being laid off or a mortgage foreclosure — can sometimes rationalize committing acts they may not have considered when times were better. Again, increased oversight can help mitigate the risk of fraud.
- **Those living beyond their means.** Employees who dress too well or drive expensive cars in relation to their pay scale may already be committing fraud.

Note that while none of these necessarily suggest that fraud is being committed, they may indicate a heightened fraud risk. A tip from an employee, customer or vendor usually reveals occupational fraud.

Small businesses usually suffer the most from occupational fraud. The dollars lost may be less than in highly publicized cases, but the impact is usually greater. Improving your business processes and knowing your employees are essential to reducing fraud risk during tough economic times.

Call or email me at sswann@bobermarkey.com to discuss how to prevent and detect fraud in your business. ■



Know the Difference: Employee or Independent Contractor

Understanding the difference between two kinds of labor relationships becomes more important in a business environment like this one.

In a struggling economy, companies will try almost anything before they resort to laying off workers. Concern for employees and their families, as well as the need to minimize disruption, leads the company to raise prices, cut more waste, borrow money and take other measures before letting people go.

But in a deepening recession these steps may not be enough, and then companies are forced into a well-defined pattern. At first a hiring freeze and attrition may be enough to reduce the payroll, but when they're not, companies lay off. And they sometimes cut too deep.

In the economy as a whole, manufacturing activity may slow, but it never stops. Business and commerce go on, marketing efforts bear fruit and orders must be filled.

Not Hiring. Help Wanted. When new orders come, a company may find itself in need of labor quickly. But no one knows initially whether those orders represent the start of a real recovery or merely a short-lived spike, so the company may be reluctant to hire (or rehire) regular full-time employees.

Under such circumstances companies often look to temporary contract workers, who are either employed by a temporary staffing agency or working, on their own, as independent contractors.

The latter category presents a unique set of problems, which Microsoft knows all too well. In 1993, the corporation's "permatemp" workers — independent contractors with long tenure — sued for the benefits, 401(k) contributions and ESOP participation rights that regular employees enjoyed. The courts upheld the ESOP claim, saying the workers were "common law employees," and two years later Microsoft settled the benefits and 401(k) claims for \$97 million.



By Paula S. DiVencenzo, CPA, M.Tax, CIT, Tax Senior Manager and Lori A. Sheets, CPA, A&A Senior Manager

The IRS maintains a detailed and complex set of rules that determines a worker's relationship with an employer. The stakes can be substantial: The determination governs the employer's responsibility to furnish benefits, as well as to withhold and pay income, unemployment, Social Security and Medicare taxes. The employment relationship also establishes the employer's obligations under various labor laws, as well as its liability for a worker's negligence. And mistakes in categorizing can draw fines.

What's the Difference? The main principle that determines whether workers are employees or independent contractors is the "right of control" in three areas: behavioral, financial and type of relationship.

Behavioral: If an employer dictates when, where and how work is to be performed, the worker is most likely an employee. But if the employer controls only the result of the work, and not the means and methods of accomplishing it, that indicates the worker is an independent contractor.

Financial: Control also applies to the financial aspects of a job. Obviously, an employer controls all of these for its employees. But if a worker incurs unreimbursed expenses, invests in or maintains separate facilities, or has an opportunity for profit or loss, that worker is more likely an independent contractor.

Type of relationship: The "perceived relationship"

is important, too. The job's permanency, the worker's availability for other work and how integral the worker is to the business itself are some of the key factors that contribute to this perception.

Why the Ambiguity. The reason these tests point to "likely" or "unlikely" conclusions is that the IRS considers multiple factors within each of the above categories. Some might assign an individual to employee status even while others indicate an independent contractor. The tax agency stresses that the "totality" of these various tests must be considered.

The rules cover many areas. Employees generally report at specified times and use the employer's tools. Independent contractors set their own schedules and usually have their own tools and a "significant investment" in the facilities where the work is performed. Employees sometimes receive paid training, but independent contractors rarely do. And while employees perform their own work, contractors are typically free to assign the work to their own employees or subcontractors.

While an employee receives compensation at regular intervals, via paycheck, independent contractors are usually paid by the job. Employees generally work for one employer at a time, and aren't available to the general public, but a contractor might serve several companies at once.

Even brief upturns call for more labor in manufacturing and distribution industries. When that happens, hiring or contracting decisions are posed quickly, because a company's agility is a critical competitive advantage in these times. To avoid the consequences described above, make sure you address these decisions with all the facts.

Employment relationships can be tricky, and mistakes can be costly. If you'd like to know more about your company's options, please call or email either of us at pdivencenzo@bobermarkey.com or lsheets@bobermarkey.com. ■

profiles

In this feature of InfoLetter, each quarter we provide a profile of one of our professionals available to work with our clients and friends.

Michael J. Moldvay, CPA

Senior Manager – Assurance and Advisory Services

With more than 14 years of experience, Mike provides traditional audit, review and compilation services to clients in a variety of industries including manufacturing, retail and distribution. Mike also has significant experience in the area of employee benefit plan audits, especially defined contribution plans.

Specializations: Manufacturing/Distribution, Retail, Employee benefit plans/ESOPs, Agreed-upon procedures/SAS 70

Education

- Bachelor of Science in accounting, The University of Akron Honors Program, cum laude
- Member, business honor society, Beta Gamma Sigma
- Vice president of Finance, accounting honor society, Beta Alpha Psi



Professional and Civic Memberships and Activities

- American Institute of Certified Public Accountants
- Ohio Society of Certified Public Accountants
- Graduate, Class XXIII of Leadership Akron
- Treasurer, Nazareth Housing Development Corporation
- Treasurer, Board of Governors, Tuscora Park Health and Wellness Foundation
- Director and past treasurer of the Akron/Canton Regional Foodbank
- Past board member and treasurer, TorchBearers
- Past member, Board of Trustees, Choices Community Social Center

Awards and Accolades

- Greater Akron Chamber 30 for the Future recipient, 2008

BMF has the expertise one would expect from a national CPA firm, with the close partner/manager attention that allows us to achieve "trusted advisor" status with our clients. I have had the opportunity, in these turbulent economic times, to provide some clients with critical-care assistance as they fought through some real challenges in their businesses, from dealing with reductions in profitability to suffering from debt covenant violations with their banks. ■

bmf services

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about our staff

Bober Markey Fedorovich is pleased to announce the following promotions of our associates to new positions within the firm:

- **Vanessa Anton** – to manager, Assurance and Advisory Services
- **Jennifer Elsass** – to supervisor, Assurance and Advisory Services
- **Melissa Dunham** – to supervisor, Taxation Services

Danielle Kimmell has graduated from Class XXV of Leadership Akron. Additionally, on September 16 she presented “FASB Codification” to the Akron/Canton Chapter of the Institute of Management Accountants.

Due to excellence in service to the firm and its clients, **Cindy Mitchell** was nominated by the firm for the Goodwill Industries of Akron’s Employee of Distinction Award and was honored at the September 9 luncheon ceremony.

At the PKF North American Network’s annual national conference on July 13 in Naples, Fla., **Jim Merklin** presented “403(b) Plans – Audits and Opportunities for Auditors.” Due to the popularity of this session, Jim was asked to repeat the presentation in a national webcast for PKF on September 10. Jim has also been appointed to the AICPA’s national Employee Benefit Plans Expert Panel.

The Hower Community Service Award was presented on September 23 to **Mary Ann Freedman** for her tireless service to children’s causes in Summit County.

Jim Bowen presented “FIN 48: Technical Practice Issues” on September 30 at the National Tax Conference in Independence.

Congratulations to Founding Partner Stanley Bober, who will receive the Vision Award from the Shaw Jewish Community Center and Lippman Day School on November 14. For details about the event, please contact Todd Rockoff at the Shaw JCC at (330) 835-0021. ■



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