

Divestitures

APPLYING A FIVE-STEP PROCESS

William J. Gole

What is the issue?

Corporate divestitures are common but complex transactions that are often poorly planned and executed.

Why is it important?

Without proper planning and adequate resources the divesting company is likely to impair the value of the transaction and, ultimately, reduce the value of the company.

What can be done?

A properly structured approach enables organizations to efficiently and effectively manage corporate divestiture transactions while optimizing their value.

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For information regarding permission, please contact permissions@cpacanada.ca

CPA Canada
277 Wellington Street West
Toronto, ON Canada M5V 3H2
T. 416 977.3222 F. 416 977.8585
www.cpacanada.ca

Applying a five-step process

Corporate divestitures are merger and acquisition (M&A) transactions that involve the sale of part of a business, such as a subsidiary, business unit, division, or product line.

Divestitures have characteristics that differentiate them from other M&A transactions, such as the need to separate or “disentangle” a business being sold from the parent organization. Managers who have only participated in acquisition transactions may see divestitures as a mirror image of acquisitions and fail to understand the fundamental difference between the sellers’ and buyers’ perspectives. After the decision to sell has been made, the seller will focus on planning the transaction and preparing the information for the transaction. The acquirer will focus on reviewing, analyzing, and validating the information provided by the seller. In addition, the announcement of the sale generally occurs months before the identity of the buyer is known, resulting in a period of uncertainty during which the business unit is vulnerable to



lack of employee motivation, loss of productivity, and erosion of its assets. These factors make divestitures challenging transactions to execute effectively.

Why organizations choose to divest

As market conditions change, organizations need to adjust their strategies and business portfolios to ensure they are optimizing shareholder value. This adjustment

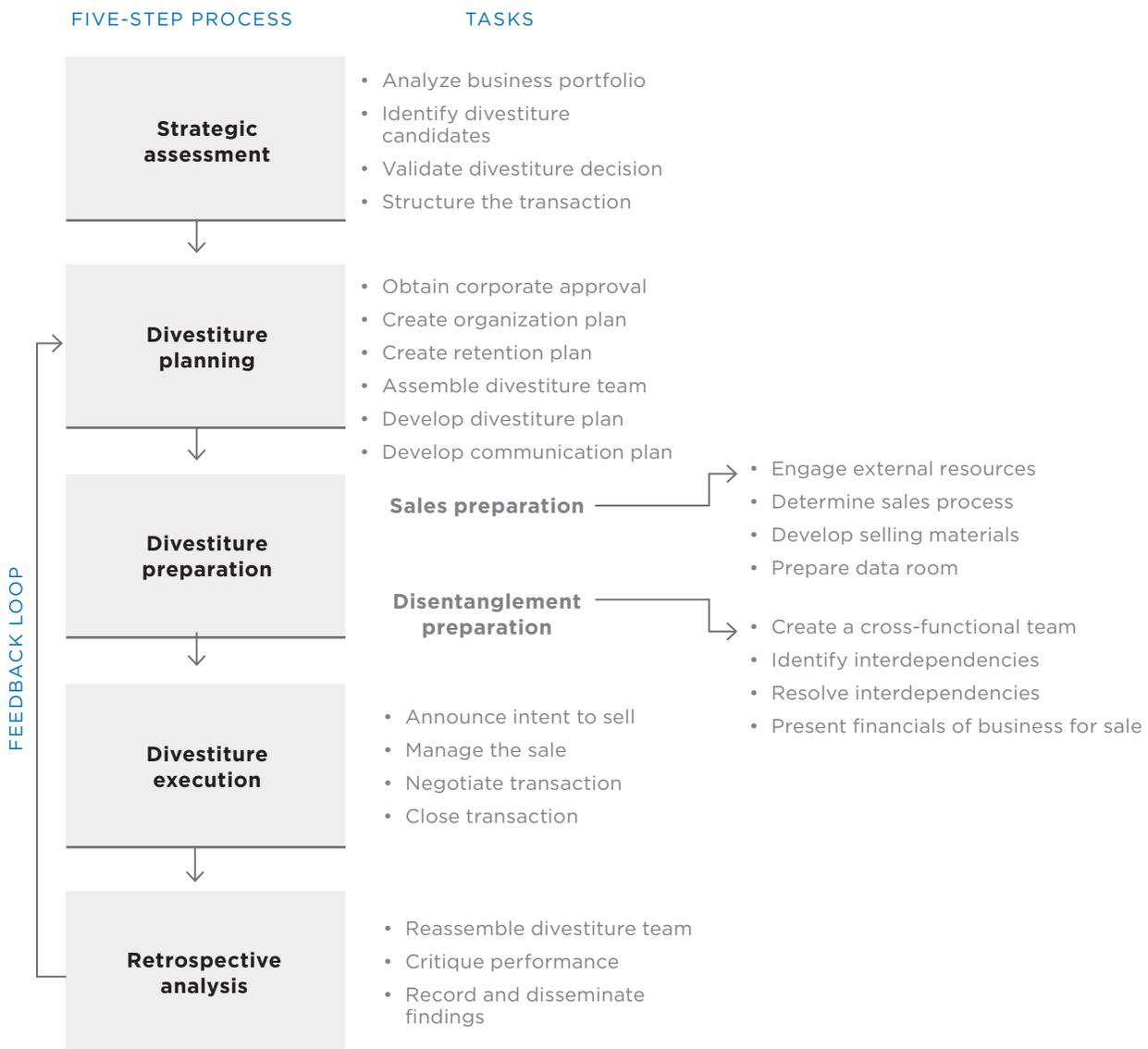
process may include disposing of business units in order to free up finite financial and managerial resources that can then be utilized to pursue higher value opportunities such as acquisitions, internal investment projects, or stock buybacks.

An overview of corporate divestitures

Divestitures are complex transactions that consume resources. They regularly occur and are material in size. Over the last decade, there have been over 3,000 divestitures per year in North America. The

average sales price of these divested businesses was \$175 million. Given their frequency and size, the efficient and effective execution of divestitures requires a high degree of discipline and structure. Figure 1 presents an overview of a five-step model that provides the basis for optimizing results. Each of these five steps, in turn, is comprised of a series of sub-steps, herein referred to as tasks. The associated tasks are listed beside each step in bullet form.

FIGURE 1 Divestiture process model

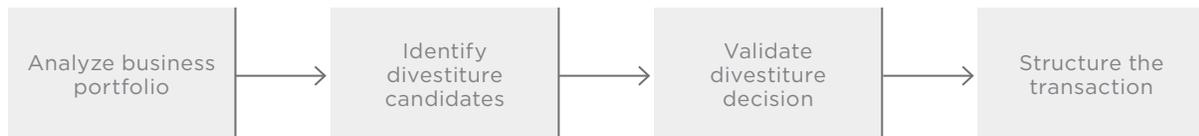


STEP 1

Strategic assessment

Figure 2, the strategic assessment tasks in the divestiture process, consists of an analysis of the organization's business portfolio, the identification and qualification of divestiture candidates, valid divestiture decision and the determination of the optimal form of the transaction.

FIGURE 2 Strategic assessment tasks



Analyze business portfolio

This analysis generally takes place within the context of the strategic planning process. An aspect of the planning process is the evaluation of all business units to determine their compatibility with the long-term objectives of the organization.

Identify divestiture candidates

In attempting to determine the compatibility of the various elements of their business portfolios, individuals conducting the analysis should ask the following questions:

- Are the markets served by the individual businesses stagnating or contracting?
- Are there macro-level forces such as changes in demographics, technologies, or regulations that will cause businesses to stagnate or contract in the future?
- Are there competitive dynamics that will reshape the market to the organization's disadvantage?
- Are any businesses in isolated market positions that have no synergistic relationship with the broader portfolio?

The answers to these questions will indicate if any business units are incompatible with the organization's strategic objectives and long-term growth goals. Occasionally, divestiture candidates may also be targeted for financial or other non-strategic reasons, such as the need to generate cash or the inability to integrate a previously acquired business.

Validate divestiture decision

Poor performance may indicate, but does not necessarily equate with, strategic incompatibility. Other factors such as poor management, underinvestment, or market disruption may have impacted the business unit's performance. In such cases, it is desirable to address the underlying causes rather than divest that property. In fact, the decision to divest should be supported by strong evidence that it is the preferred course of action — one that is based on a thorough analysis of the transaction's strategic and financial implications. In addition, given divestments require a significant amount of managerial time, resources, and risk, it is necessary for the organization's management team to commit to making the divestiture a success.

Structure the transaction

Once a preliminary divestment decision has been made by management, the next step is to determine the form and structure of the transaction that is most likely to optimize after-tax proceeds of the prospective divestment. The available divestment options include the: 1) outright sale of the property or properties to be divested; 2) creation of a separate entity in which the corporation may or may not retain an ownership interest; and 3) swap of assets with another corporation, which may include other considerations such as cash. Creation of a separate entity can be a very attractive option under certain circumstances. This is the situation when the business unit being divested is relatively large, that is, the unit is truly a stand-alone entity (a free-standing division or subsidiary with its own support infrastructure), and the value generated

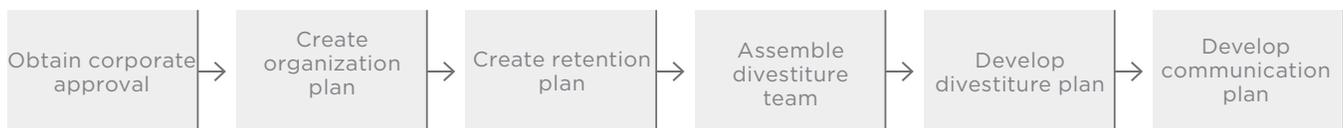
is materially greater than an outright sale. The major benefit of this option is that unlike an outright sale which can generate substantial tax liabilities, creating a separate entity generally results in a non-taxable transaction. However, this type of transaction requires substantial legal, regulatory, and advisory costs, as well as management attention. Because of all the factors noted, company spinoffs, while an attractive option in certain situations, are relatively rare. Asset swaps only make sense when even more rare conditions (mutually beneficial exchanges of properties) are met. As a result, the most common form of divestiture is the outright sale of the asset.

STEP 2

Divestiture planning

Once there is preliminary agreement that a divestiture is desirable, the planning step in the process should be initiated. Figure 3 illustrates the major divestiture planning tasks.

FIGURE 3 Divestiture planning tasks



Obtain corporate approval

Approval to move forward on a divestiture typically takes the form of a document that presents a well-considered recommendation to the corporation's CEO and the board. Its major components would be the strategic rationale underlying the recommendation, a background discussion of the business and its markets, valuation estimates, a description of alternative transactional approaches that were considered, and a description of the planned divestiture process contemplated, as well as a timeline for planning, preparing, and executing the transaction.

Create organization plan

It is not uncommon that business units that are candidates for divestiture have been part of the parent organization's portfolio for an extended time. As a result, an environment of functional interdependency and shared operational infrastructures is likely to have evolved over time. A major objective of untangling the two entities is to present the business unit being divested as a stand-alone entity to the greatest extent possible so its sales potential can be optimized by making it attractive to the broadest possible range of potential buyers. The initial effort to rationalize the infrastructures is the establishment of an organizational plan that includes:

- **Determining business unit leadership.** This would typically include the business unit's chief executive and senior management team.
- **Performing an operational analysis.** This process consists primarily of identifying all the customer-related operations and functions.
- **Performing a preliminary infrastructure analysis.** Although a detailed evaluation of shared services will not be done until a dedicated team is assigned later in the process, the basic functions necessary for the unit to approximate a stand-alone business should be identified.
- **Assigning employees.** Based on the operational and infrastructure analysis, a preliminary determination of those individuals who will staff the unit and those who will be retained by the parent organization should be made.

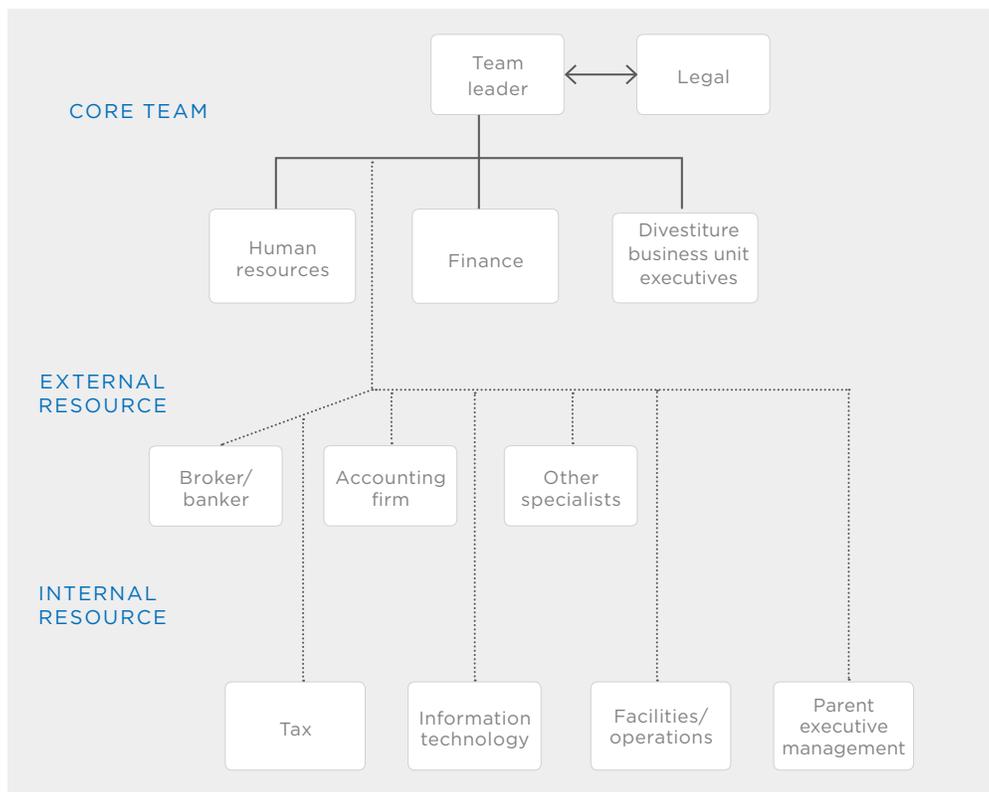
Create retention plan

To ensure that any potential for business erosion is minimized all key individuals should be identified as early as possible in the process. A plan should be formulated to reward them for staying with the business unit until it is sold.

Assemble divestiture team

A critical element of the planning process is the creation of the team that will help formalize the divestiture plan, drive the divestiture process, and ensure it stays on track. The divestiture team is typically composed of a core team of senior executives; external consultants and advisors; selected internal experts and managers; and is led by a clearly empowered designee of the CEO of the parent organization. An outline of the divestiture team structure is illustrated in Figure 4.

FIGURE 4 Divestiture team structure



Develop divestiture plan

After the team is formalized, it needs to develop a detailed divestiture plan under the direction of the team leader. This detailed plan should:

- Outline the key activities in the transaction;
- Identify all material tasks, deliverables, and milestone accomplishments for the transaction;
- Assign responsibility and establish deadlines for those tasks, deliverables, and milestones;
- Identify key decision points associated with making and executing decisions; and
- Identify any major risks associated with the transaction.

Develop communication plan

Implementation of the communication plan, including the actual announcement of the prospective transaction, does not occur until the execution step (**Step 4: Divestiture execution**) of the process. However, development of the communication plan should begin as soon as possible after the decision to sell has been made and the team has been assembled. The communication plan consists of two major elements: 1) messages directed at external constituencies such as customers, suppliers, shareholders, lenders, and the larger investment community; and 2) messages directed at internal constituencies, such as the management and employees of both the organization being divested and the parent organization. Although this messaging should be customized to address the issues relevant to each discrete audience (as described in announce intent to sell on p. 12), the selling organization will want to convey the following core points to all constituencies:

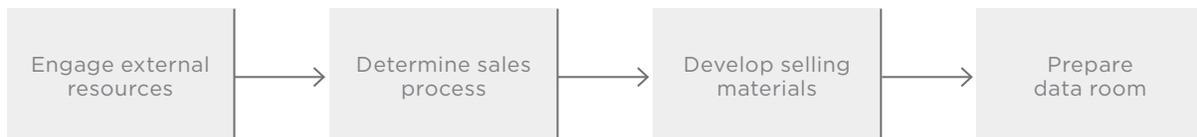
- The announcement of the intent to sell;
- The strategic rationale for the divestiture;
- The attractiveness of the property being sold;
- The identity of the financial advisor assisting in the sale; and
- An indication of the anticipated timing of the transaction.

STEP 3

Divestiture preparation

The preparatory step runs on two distinct, but concurrent, tracks: 1) getting resources and materials mobilized for the sale (i.e., sales preparation); and 2) preparatory measures to ensure the controlled separation of the business being sold from that of the seller and the resultant impact on financial statement presentation (i.e., disentanglement preparation). The tasks that comprise the first of these, preparing for the sale, are illustrated in Figure 5. The ensuing discussion is followed by a description of the disentanglement activities (p. 9) and the development of the financial statements of the unit being divested on a stand-alone basis.

FIGURE 5 Sales preparation tasks



Sales preparation

- **Engage external resources.** The main external resources required to effectively divest an asset are a financial advisor (a business broker or investment banker) and an independent accounting firm. It may also be desirable to engage other professional resources, such as advisors with regulatory or legal expertise.

The financial advisor is engaged to advise and manage the transaction. Advice generally takes the form of guidance on the valuation of the business, the structure of the transaction, the selling approach employed, and buyers to be targeted. The advisor also develops the selling materials and orchestrates the sale.

Independent accountants are engaged by the seller to perform specified procedures relative to the financial information that will be provided to buyers. The nature and extent of the procedures will depend on the intended use of the financial information. More often than not, audited financial statements (for up to three years) may be required by buyers seeking to comply with the requirements of their lenders or regulators, while less intensive review procedures may be sufficient to provide comfort to buyers not requiring audited financial statements.

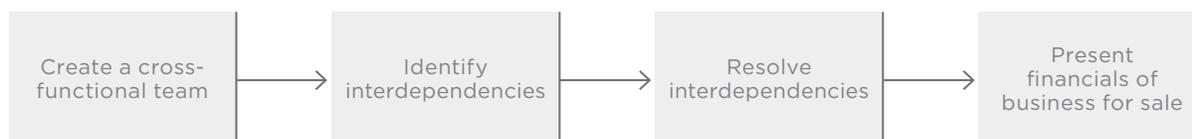
- **Determine sales process.** The core divestiture team members and the financial advisor typically collaborate on identifying potential purchasers of the business unit. The divestiture team will have an informed view of the potential market by virtue of having been a market participant. The advisor should be equipped to supplement that view. The advisor may also have relationships with potential financial buyers (e.g., private equity firms) that are unknown to the divestiture team. From their collective reading of the market and the preferences of the selling organization, the divestiture team and the advisor can determine whether it is best to bring the business to market via an auction, or rather entertain a pre-emptive bid by a single buyer. The auction process is the most common sales approach employed by sellers and is described in detail in **Step 4: Divestiture execution**.
- **Develop selling materials.** Selling materials typically consist of the following three elements: 1) a “teaser,” 2) an offering document, and 3) a management presentation. A teaser is a document that contains information on the business, along with an abbreviated financial profile. The offering document (also referred to as an offering memorandum or prospectus) contains a substantive description of the business, its historical financial performance, and its strategic potential. The management presentation, typically a PowerPoint presentation, mirrors the content of the offering document and is the basis for live presentations to selected potential buyers by the executive management team of the business being sold.
- **Prepare data room.** The financial, legal, and operational information subject to review by potential buyers is housed in a data room. The examination of this information provides an opportunity for bidders to assess the veracity of data underlying the seller’s representations.

Disentanglement preparation

In relatively rare instances, the disentanglement process is simple. This is the case when the business unit being sold is a stand-alone business, such as a free-standing subsidiary, or a division of the seller that has its own supporting infrastructure. However, in order to get the business unit ready for sale, it must be disentangled from the seller’s infrastructure. In the effort to separate the business unit from the seller, certain infrastructure gaps will almost certainly result. In these situations, the seller is faced with a decision of whether to fill those gaps and create a self-sufficient entity or do nothing. The competing forces at work in that decision-making process are the desire to maximize the size of the buying market and the potential sales price, and the desire to minimize the costs associated with filling gaps in the business unit’s infrastructure. Generally, the closer the seller can get to the presentation of a stand-alone business, the greater the pool of potential buyers and the greater the upward pressure on price. Those business units with significant gaps in their infrastructure will be faced with a limited pool of operating companies (e.g., strategic buyers) with sufficiently robust infrastructures to support the unit being acquired. As the infrastructure gaps are narrowed, the field will generally expand to include smaller strategic buyers and possible financial buyers (e.g., private equity firms with operating businesses in their portfolios). If the business unit can be presented as a self-sufficient entity, the number of potential buyers may expand to include other financial buyers that do not possess the capability to provide infrastructure support.

The tasks of the disentanglement effort are illustrated in Figure 6.

FIGURE 6 Disentanglement preparation tasks



- Create a cross-functional team.** Before interdependent relationships between the two entities can be resolved, the seller must engage in a thorough information-gathering effort that starts with creating a cross-functional team soon after the decision to divest is made. This team should be charged with responsibility for identifying all material interdependencies between the selling corporation and the business unit being sold. It should include representatives of all relevant support functions from both the seller and the business unit and be led by a member of the core divestiture group, ideally a finance professional. This team leader should: 1) have a broad-based understanding of both businesses, 2) have sufficient organizational influence to direct a cross-functional project and make key decisions, and 3) be capable of quantifying the effects of those decisions on both entities.
- Identify interdependencies.** The most obvious interdependencies involve functions such as HR, accounting, information technology, and other “back office” support services provided by the parent organization to the unit being divested. However, there are less obvious interdependencies. These include items such as commercial agreements or intellectual property rights, which benefit more than one of the seller’s business units. In addition, there may be services, agreements, or assets provided or owned by the business unit that are also utilized by business units the seller will retain. The first task of the disentanglement team is to perform a comprehensive review and identify these interdependencies.
- Resolve interdependencies.** The seller must decide whether it is in its interest to transition the business unit self-sufficiency, or if it is preferable to do as little as possible and have the acquirer assume the burden of providing that support. The answer to that question strongly influences the seller’s perception of the benefits that self-sufficiency (or near self-sufficiency) offers in terms of the number and quality of additional organizations that might join the pool of potential acquirers.
- Presenting financials of business for sale.** The final disentanglement preparation task is the development of stand-alone financials. Potential buyers of a business being divested usually expect the seller to present financial information on a stand-alone basis (i.e., as if it were a self-supporting business, without the operational and administrative support of its corporate parent, and therefore closely representative of the business to be acquired). In addition, many buyers will want to obtain financial statements that have been audited by an independent accounting firm as part of its own due diligence or to satisfy lender or regulatory requirements. As previously noted, this often presents a challenge for the seller because in many cases the business being divested has been integrated into, or shares support services with, a larger entity. Further, its financial records are unlikely to have been subjected to a dedicated audit, but instead only reviewed as a component of the parent organization’s consolidated financial accounts. To satisfy the requirements of potential acquirers, the seller will usually engage in a multi-step process in which the internal financial records are subjected to a specialized audit (often referred to as a “carve-out audit”). This, in turn, is used as a basis for developing pro forma financial information that presents the business on a stand-alone basis.

It is important to note that carve-out financial statements present the results of operations of the business *as owned by its corporate parent*. This means that although costs for items like shared support services are allocated to the business unit, these costs are not representative of the costs the business would incur if it were truly a stand-alone entity. Prospective acquirers usually expect sellers to provide additional financial information prepared on a “stand-alone basis” to enable analysis against comparable businesses on a like-for-like basis. Consequently, sellers normally prepare stand-alone pro forma financial information

to complement the audited financial statements. In addition to presenting the business as if it operated on a stand-alone basis, this information also highlights any unusual or non-recurring transactions in the historical results, so prospective acquirers can base their valuations on the true ongoing “run rate” of the business. For prospective acquirers to understand the differences between the audited and pro forma financials, sellers customarily prepare a reconciliation or bridge schedule, such as the one below, that itemizes and explains each difference.

TABLE 1 Illustrative bridge schedule

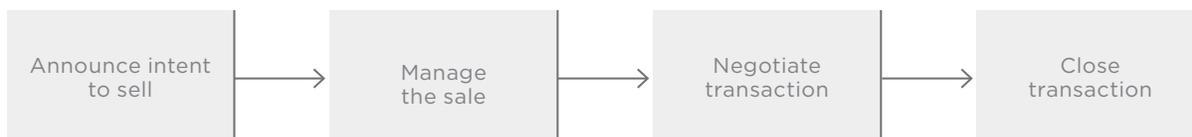
	REVENUES	EXPENSES	NET INCOME
Audited carve-out income statement	\$x	\$x	\$x
LESS: Internal cost allocations for services provided by other business units		- \$x	+ \$x
ADD: Estimated costs to provide services on a stand-alone basis		+ \$x	- \$x
+/- Non-recurring or unusual items	+/- \$x	+/- \$x	+/- \$x
Pro-forma income statement on a stand-alone basis	\$x	\$x	\$x

STEP 4

Divestiture execution

Once the preparation step has been completed, the next step is for the team to initiate the sales effort, which consists of the following tasks:

FIGURE 7 Divestiture execution tasks



Announce intent to sell

Up to this point in the divestiture process, most of the planning and preparatory activity has been conducted by a relatively small team in a confidential setting. After a public announcement of the impending sale, the environment changes dramatically. Shareholders will want to understand the impact of the divestiture; potential buyers will want to know whether the business being sold presents them with an attractive opportunity to expand their market presence; customers of and suppliers to the business being sold will want to know how the prospective transaction will impact their relationship with the unit being divested; and employees of both the selling corporation and the business being divested will want to know what this means for them. These concerns present a challenging environment for the divestiture team. Actual announcement-day activities are divided between the external announcement to the public and internal communications with employees. The corporation would typically make the public announcement through a press release. Very large divestitures by major corporations may require a more elaborate announcement process and include discussions with analysts who track the markets in which the divesting company participates. Post-announcement activities will also include communication with customers and vendors. The basic message to these constituencies should be “business as usual,” with emphasis on continued superior customer service and supplier relations.

Employee announcements generally require more detailed logistical and thoughtful planning. The employees of the business being divested should be informed of the prospective sale, preferably in person by a senior executive of the selling organization at a pre-scheduled employee meeting. Employees of the selling organization should be informed at the same time. This constituency's interest will generally focus on whether the divestiture portends further divestment activity in the near future that may affect them. Once that concern is satisfied, the potential for distraction among this group is sharply reduced. Employees of the business being sold will invariably require more attention. It is good practice to distribute a package of information at the time of the announcement that addresses employee concerns and make HR personnel available to answer questions right after the announcement. In addition, a mechanism to receive and respond to employee inquiries, such as a dedicated email address or website for questions and/or periodic updates by business unit senior managers, should be considered.

Manage the sale

Unless there is a preference for keeping the transaction confidential and closing it quickly (a relatively rare situation), the divestiture team will execute a highly structured and deliberate auction sale. This will entail soliciting initial bids, qualifying those bidders, inviting those who have been qualified to perform due diligence, soliciting final bids, and selecting a "winner."

- **Soliciting initial bids.** Initial bids are solicited after distributing the teaser. Firms who respond to the teaser with an expression of interest would be required to execute a non-disclosure agreement (NDA), which is an agreement not to disclose aspects of the transaction or to solicit employees of the seller. Those bidders that clear this initial hurdle then receive the offering document with a request for an initial bid and a description of how the bidding process will be managed.
- **Qualification of bidders.** Although bids made at this stage are non-binding, they do indicate a measure of bidder seriousness and will be evaluated by the seller and the financial advisor. The seller will rely heavily on the advisor's ability to evaluate the credibility of the bidders, their ability to obtain financing, and their commitment to closing a deal.
- **Invitation to proceed.** A limited number of bidders will be invited to proceed to the preliminary due diligence stage of the transaction. Although there is no ideal number of qualified bidders, the field will generally consist of several, perhaps a half-dozen, interested parties. Due diligence will consist of a management presentation and interaction with the business unit's senior management, the opportunity to gain access to a data room, and possibly a tour of the business unit's facilities. At this stage of the auction, limits may be placed on the data provided in the data room, such as by redacting proprietary information about specific customers or product development activities. After the field has been narrowed to a single buyer in the final stage of the bidding, that information would be released as part of what is generally termed confirmatory due diligence.
- **Final bids.** Participants in the auction will be asked to make their best and final offers after the preliminary due diligence phase of the process. Frequently, they will also be asked to markup a copy of the purchase agreement that has been prepared by the seller's legal team. The seller will then determine the winning bidder who will be accorded an opportunity to perform confirmatory due diligence. The determination of the winning bidder will be made based on price, other major terms of the transaction, and confirmation of the buyer's ability to finance the transaction. Although sale price is the major determinant, a lower bid may be entertained if the high bidder responds with serious modifications of the agreement, or if there is any doubts regarding the bidder's ability to obtain financing.

Negotiate transaction

After a single finalist has been determined, the negotiation of the contracts and ancillary agreement begin in earnest. These normally include the purchase agreement and disclosure schedules to the purchase agreement. They may also include a transition services agreement (TSA), a commitment of the seller to provide certain support and back-office services to the acquirer for a limited period while the buyer transfers the business unit to its ownership. The purchase agreement is the definitive legal document governing the divestiture. It sets forth the financial and legal terms of the transaction. The disclosure schedules list all the disclosures the selling corporation has made, and itemizes any exceptions to its representations and warranties. Items included in the schedules are cross-referenced to the appropriate section of the Agreement, effectively modifying that section. For example, a representation that there is no litigation *except as disclosed* in the corresponding schedule can have a material impact on the transaction. Disclosures, therefore, mitigate the seller's legal and financial risk.

- **Contract negotiation.** The initial version of the purchase agreement is drafted by the seller's legal team. By creating the first draft, the seller sets in place its preferred transaction structure and establishes the initial allocation of risk between the parties. What follows is an iterative process whereby the buyer marks up the contract, the seller reviews and edits it, and then routes it back to the buyer. These iterations shift risk and costs back and forth between the parties until they reach a mutually acceptable agreement. After all contractual issues are negotiated and resolved, the parties can move to the closing of the transaction.

Close transaction

The closing of the transaction can occur immediately upon signing the purchase agreement or, after a defined interval, following satisfaction of certain conditions or requirements. Simultaneous signing

and closing are common with smaller transactions. Frequently, though, it is necessary to separate the two. This is the situation when one or more of the following conditions must be met:

- **Buyer financing needs to be finalized.** If third-party debt will finance the transaction, a period of time will generally be needed to finalize these arrangements.
- **Government approvals must be obtained.** Transactions above a certain size or with certain characteristics may require governmental approval. These requirements generally relate to assessing any potential impact of the transaction on competition (i.e., anti-trust concerns).
- **Third-party consents are needed.** In some cases, consents of third parties other than the government are needed before the transaction can close. If the transaction is structured as an asset sale, certain material contracts may not be assignable without third-party consent.

STEP 5

Retrospective analysis

Retrospective analysis of the entire transaction by the core divestiture team is a straightforward but often overlooked opportunity to institutionalize what was learned from the experience. A modest investment in time will allow the organization to reap the benefits of lessons learned from the recently closed transaction. This can take the form of a one-day meeting of all team members at which all major aspects of the transaction are reviewed. Questions such as the following should be used to stimulate team member inputs:

- *What went well and why?*
- *What could have gone better and why?*
- *How did the external advisors (particularly the financial advisor) perform? Should they be used in the future?*
- *Was the communication plan effective? How might it be improved?*
- *How did the internal team perform? What measures (such as training) might be taken to improve staff performance?*

Discussions around these types of questions should generate observations and recommendations about process improvement and improved utilization of resources in the future. The team leader should distill this input into a process feedback report that captures important observations and recommendations, and ensure it is distributed to the appropriate personnel and properly archived.

Corporate divestitures are usually complex and time- and resource-consuming transactions. They are also important opportunities for organizations to adjust their strategies and business portfolios in ways that can create value for their shareholders. To optimize these transactions, organizations must recognize the importance of employing a highly structured and disciplined process led by a properly resourced and empowered team. □

This publication is one in a series on *Divestitures*. An Overview and Case Studies are also available on our website. For additional information, please contact Carol Raven, Principal, Strategic Management Accounting & Finance at 416-204-3489 or email craven@cpacanada.ca.

Additional sources of information

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About the author

William J. Gole, MBA, CPA, is a business consultant, educator, and author of professional books and continuing professional education courses for financial professionals. Mr. Gole began his career as an auditor with Coopers & Lybrand and has held a variety of financial and strategic planning positions throughout his 30-year career. From 1998 through 2004 as senior vice-president, planning and business development for the Thomson Corporation, he had responsibility for strategic planning and M&A activities for Thomson’s health care division, including the management of several dozen acquisitions and divestitures.



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