S+C Partners LLP
CHARTERED ACCOUNTANTS

Succession Strategies – Creating a Plan for Selling Your Business

WHITE PAPER

Succession Strategies – Creating a Plan for Selling Your Business

Most entrepreneurs spend time and resources to create a thoughtful, written plan to start up a business. They know that a detailed business plan is essential to secure financing, anticipate potential obstacles and maximize revenue and profit growth.

However, only 35 percent of small business owners invest the same time and resources to develop a formal succession plan for their business. Yet succession planning is as essential as start-up planning and for exactly the same reasons. It can help secure financing for ongoing operations, minimize transition issues and ultimately maximize the value of the business.

The Importance of Planning Ahead

With the benefits so great and the potential downsides so damaging, succession planning is clearly critical to any privately owned business, no matter its size. Why then are so few business owners engaged in succession planning?

What is a succession planning?

Succession planning is the process of determining the "how" and the "when" of a successful planned transfer of the ownership of a business. It is a process, not a paper document, although writing down a formal plan helps ensure it is thorough and easily shared with family members, employees and other interested parties. Since it is a process, succession planning can evolve over time with changing circumstances.

Benefits of succession planning

By engaging in the succession planning process, business owners are compelled to identify and address issues that can have a significant impact on the value of their business. For example, owners may have accumulated significant goodwill in their business that should be recognized before ownership is transferred to another party. Additionally, the business should be structured in a way to minimize taxes when ownership is transferred. For example, special considerations regarding business structure are needed to qualify for the $750,000 lifetime capital gains exemption in Canada.

Transparent succession planning can also help maintain harmony in family-owned businesses. Clearly designating a future leader and ownership structure can help defuse anxiety and uncertainty among family members. Having a plan in place can help protect and preserve business value in the event of a crisis that triggers an unexpected transfer in ownership.

Finally, succession planning is an important component of financial planning for any business owner. The process can help ensure that the owner's financial needs will be met in retirement, for example. It also provides essential input for estate planning and probate planning.

The potential costs of not having a viable succession plan are substantial. Ultimately, the business may fail due to an unsuccessful transfer of ownership. At the least, value could be significantly diminished and lead to insufficient retirement income for the business owner or his beneficiaries. Additionally, squabbles or feuds over ownership can tear families apart and lead to a loss of control.

Barriers to succession planning

In a 2005 survey of business owners by the Canadian Federation of Independent Business (CFIB), 71 percent of entrepreneurs reported they intend to sell their business in the next 10 years. Yet only 35 percent said they had a clear plan to exit their business. Only 7 percent had committed their plan to writing. Even worse, less than 20 percent of respondents had any idea what kind of income stream to expect.

It's not surprising then that only 20 percent of small and family businesses are actually sold. Or that only one-third of family-owned businesses transition from the founder to a family member of the next generation.

The reasons most cited in the survey by business owners for why they did not have a succession plan are: too early to plan for succession, no time to deal with the issue, can't find adequate advice or tools to start and too complex.

Overcoming these barriers requires an understanding that succession planning offers immediate benefits to the current owner and to the successor. Operating a business as if it is for sale today helps manage risk and improve stability. In the CFIB survey results, business owners with a succession plan in place agreed that the plan assisted in providing for their families in the future. They also agreed that they had minimized future tax liabilities and improved the financial stability of their business. Additionally, successors benefit from increased training and exposure to the ins and outs of running the business.

To address the time constraints as well as the tax and legal complexities of succession planning, business owners should retain a team of experienced professionals. The team should include a chartered accountant and tax advisor, an investment advisor, a lawyer and a chartered business valuator.

Beyond external professionals, key employees and family members should be part of the succession planning team. They can help answer key questions and address issues that must be considered during the succession planning process.

Issues to consider during succession planning

Since succession planning deals with a planned transfer of ownership of a business, a wide range of issues – from naming a successor to projecting financial performance – must be considered. Here are a few initial questions to consider when beginning the succession process:

Family businesses

- Is the next generation capable of running the family business?
- If more than one child is interested in the business, will they be able to get along?
- Should a potential successor gain experience working outside the family business?
- Should marital contracts be written for potential successors?
- Does the succession plan contribute to family harmony and ensure beneficiaries are equitably treated?
- Is the business interest sizeable enough to support the family's financial needs?

Any privately owned business

- Are there potential buyers of the business?
- How will key stakeholders including bankers, customers and suppliers react to the new successor?
- Who are the key managers in the business who are critical to its success?
- What is the immediate plan if the owner becomes disabled or dies tomorrow (worst case scenario)?
- Will the executors of the owner's estate be able to run the business in the short term until a successor is appointed or sale consummated?
- Can an insurance solution be incorporated into the succession plan to fund a buyout on the owner's death?

Certain key pieces of information are needed to accurately address these issues and create a viable succession plan. Included among these are financial statements and tax filings, job descriptions of key managers, existing business plans and knowledge of key stakeholders including bankers, customers and suppliers. Additionally, a reliable business valuation is essential.

Valuation

The Canadian Institute of Chartered Business Valuators defines business valuation as "the quantification of the worth of all or part of a business…" To do this, all assets and liabilities of a business that contribute to value are examined including tangible assets such as property and intangible assets such as brands.

Valuations using accepted methodologies can help set the purchase price for the sale of a business to a third party and establish value for non-arms length transactions such as a transfer between family members in an estate-freeze transaction or a corporate reorganization. Additionally, valuations can be helpful in developing appropriate wording in shareholder agreements, securing new financing and resolving family disputes.

Chartered business valuators (CBV) are individuals who meet the requirements of the Canadian Institute of Chartered Business Valuators and have been awarded its professional designation. Employing a CBV to establish business value ensures accepted methodologies are used, which can help avoid tax disputes with the Canada Revenue Agency.

Succession and Your Alternatives

Here are more detailed looks at six alternative succession strategies along with real-life examples from the S+C Partners LLP accounting practice. Understanding the implications of each alternative is a first step in developing the right succession strategy for your business.

As a business owner, you have multiple succession strategies to consider for the future of your business. If it is a family business, family members can continue to own the business but may or may not be involved in the day-to-day management. Outside of family options, you may decide to sell your business to your employees through stock option arrangements or future profits of the company. Alternatively, you may pursue a sale to a third party, reorganize or simply wind down your business.

Strategy 1 – Family continues to own and manage

When the owner of a family business decides to bring one or more children into the business, a number of control and ownership issues must be resolved. First, the needs of the current owner must be identified and addressed. Typically, the current owner will require ongoing cash flow and will want to retain control of the business until a specified date in the future. The adult children joining the business will require a fair salary and an ownership stake in the business.

Here's how these issues were addressed by S+C Partners LLP for C Company, when the owner and father created a succession plan naming his two sons as successors.

EXAMPLE 1

At C Company, the father and sole owner of the business was prepared to introduce ownership of the business to two of his three children. However, he wanted to maintain control of the company until he was able to monetize the value he had created in C Company. Additionally, the father had ongoing cash flow needs to fund his lifestyle including golf club memberships and a recreational condominium.

S+C Partners LLP advised the father to perform a tax-free corporate reorganization and exchange his common shares for preferred shares equal to the value of the company. The preferred shares were then transferred to a holding company. At the same time, the adult children subscribed for common shares. The preferred shares held by the father would be weighted so as to out-vote the children's common shares. Additionally, the preferred shares were entitled to a fixed-rate cumulative dividend payable tax free to his holding company. Other debt held by the holding company was secured against the assets of C Company and made interest bearing.

Reasonable salaries were negotiated and paid to all family members working in the business. The children were also introduced to their own independent financial advisors. Additionally, a board of advisors was established for C Company and a retirement plan formulated for the father.

A succession plan that involves this type of reorganization may be appropriate for your family business. It depends largely on the interests and capabilities of family members. Future profits and the withdrawal of capital from the business are used to look after the retirement needs of the father.

Strategy 2 – Family continues to own with outside management running the business

When family members have either no interest or lack the ability to manage a family-owned business but want to retain their ownership position, outside management can be hired. Outside management refers simply to individuals outside of the shareholding family. Most likely, an existing employee with long-term knowledge of the company will be most qualified to act as an outside manager.

Here's how the issues related to this succession strategy were addressed by S+C Partners LLP for J Company, a family-owned business that is operated by a non-family management team.

EXAMPLE 2

J Company is a mature, established business with a competent management team and well-functioning control systems. A formal board of directors has oversight and stewardship responsibilities for the company. The family that owns J Company is satisfied with the rate of return they are achieving on their investment in the business.

S+C Partners LLP adds value to J Company and its owners by annually auditing the company and reporting the results to the audit committee of the board. Additionally, S+C Partners LLP reviews, tests and comments on control systems each year and provides a written constructive services letter. S+C Partners LLP is also consulted regularly regarding business issues facing J Company including remuneration of the key employee.

Naming the outside manager or management team to succeed the current owner/manager is critical to the success of this alternative. In this case, formalizing a succession plan in writing well before the transition date can provide valuable time for the successor to fully learn and begin to operate the business.

Strategy 3 – Business is sold to key employees

When the current owner and his or her family members no longer wish to retain ownership of a successful business, they typically try to sell the business. Selling the business to key employees offers several advantages. It can help ensure that the future owners are knowledgeable and capable of successfully managing the business. This is especially important if the current owner will receive ongoing payments from the business or if the business carries the current owner's name. Additionally, this succession strategy can be used to reward key employees who have contributed substantially to the success and growth of the business.

In the following example, S+C Partners LLP advised P Company, a successful distribution business, on a transfer of ownership to two managers of the company.

EXAMPLE 3

P Company has been in the distribution business for more than 30 years. At age 50, the principal decided to begin to step away from the business to spend more time at the family cottage. The goal for the succession process was to elevate two division managers within the company to a shareholding position. The principal contacted S+C Partners LLP to assist with developing and executing a tax-effective succession plan.

As part of the multi-step plan, a S+C Partners LLP's business valuator determined the business value. Additionally, financial projections were prepared for the next five years. An offering memorandum was shared with the two managers and each manager sought independent counsel.

A portion of the business value equal to P Company's retained earnings was frozen in the form of dividend-bearing preferred shares with redemption and retraction rights.

In the executed sales agreement, the managers each acquired a 25 percent stake in P Company for a modest down payment. The principal accepted a promissory note requiring three annual payments with interest. Additionally, the principal was able to utilize and multiply his capital gains exemption, thanks to a family trust put in place several years earlier.

The success of this strategy depends on identifying key employees who are interested and capable of owning and operating the company. These employees will need their own legal and tax professionals to advise them on a transfer of ownership through stock option arrangements or future profits of the company.

Strategy 4 – Business is sold to a third party

When transfer of ownership to a family member or employee is not an option, you should then consider selling your business to a third party. Business brokers are available to help identify parties who are interested in a purchase. Brokers can also assist in the purchase price negotiations between buyer and seller. However, it is incumbent on you and your advisors to determine the value of your business and the appropriate structure of a tax-effective sale to a third party.

In this example, the owner of T Company completed a sale to a third party with the advice of S+C Partners LLP.

EXAMPLE 4

T Company, had two shareholders: a retired 85 year-old and an active 55 year-old president. The retiree owned 80 percent of T Company and was looking to simplify his estate. The president had no interest in acquiring the 80 percent ownership stake and so wanted to find a potential third-party purchaser for T Company.

S+C Partners LLP worked closely with the president to determine the business value and prepare financial projections. A tax plan was developed that took a capital gains reserve and capital gains exemptions into consideration. Assistance was also provided with the due diligence process for the potential buyer.

When a buyer was identified and a purchase transaction pending, S+C Partners LLP prepared a management transition plan in which the president was retained for a two-year period post-transaction. The transition plan also involved selecting a replacement president, developing a management team and maintaining relationships with key stakeholders.

The transition plan dovetailed nicely with the president's retirement plans. S+C Partners LLP helped establish an individual pension plan for the president that allowed him to defer most of his transition-period compensation in a tax-deferred manner. The purchaser was able to leverage the acquisition of T Company by adding incremental revenue streams and securing financing at a lower cost.

In third-party sales, many factors can enter into negotiations. While a broker can help facilitate negotiations, business owners should recognize that the broker's financial interest lies in successfully completing a sale. Many arrangements with brokers require non-refundable professional fees. Tax and legal advisors are best positioned to objectively evaluate and structure a sale to a third party to ensure the owner receives the full business value.

Strategy 5 – Business is reorganized

Over time, a company may add new locations or other lines of business to its original business plan. When it comes time to consider succession, the owner may not want to treat all components of the business in the same way. In these cases, a succession plan may call for a business to be split into distinct parts. The current owner may retain certain parts and sell others. This type of strategy may take additional time to execute, making it all the more important to begin succession planning early.

Maximizing the value of your business may entail different strategies for different parts of the business. Considering this option and then thoughtfully planning its execution is an important benefit of engaging in a succession planning process well before the actual transfer of ownership.

Strategy 6 – Business is closed

The worst-case scenario in any succession plan is the loss of the owner from either disability or death. Just as individuals have wills to prepare for this possibility, business owners should have a succession plan. Without a succession plan, you expose your family members to a significant potential loss in value and an added burden during an already difficult time. With a succession plan, a painful transition can be made less onerous.

In the following example, lack of succession planning resulted in a loss of significant business value and created unnecessary hardship for the deceased owner's surviving family members.

EXAMPLE 5

A successful 40 year-old mechanic operated a business with four employees. One weekend, the mechanic passed away suddenly from a heart ailment, leaving his wife and three young children with the business. There was no succession plan, inadequate insurance coverage and no likely successor identified to operate the company.

With S+C Partners LLP and legal counsel, the business was systematically wound down and the assets monetized to repay existing obligations. Net proceeds were distributed to the family.

The decedent had created a business largely based on individual effort and personal goodwill. Unfortunately, the value of this small business could not be transitioned successfully, due to a highly competitive marketplace and very few barriers to entry. Ideally, an insurance-based solution involving disability or life coverage would have assisted the family greatly during a difficult time.

While no one likes to contemplate any crisis, a responsible business owner prepares for these circumstances through succession planning. Doing so can help protect and preserve the business value for family members whatever the future holds.

Making It Happen

Determining the right succession strategy for your business and then formalizing it in a plan is one of the most important steps you can take as a business owner to maximize the value of your business. However, it is a complex process with significant tax and legal implications. Assembling a qualified team of professional advisors can help facilitate a successful succession planning process.

Your advisory team should include a chartered accountant who is experienced in succession planning strategies and issues, an investment advisor who is knowledgeable in retirement planning, a lawyer with expertise in business issues and a trusted personal or professional advisor who will act as your executor. A chartered business valuator can provide a reliable estimate of business value, which is vital in any succession strategy.

Succession planning should be done in the context of your other life plans including retirement and business plans. It may make sense to use the same advisory team for all planning in order to coordinate the aspects of each plan.

While succession planning may seem complex and not all that urgent, every business owner should take steps to maximize the value of their business in the event of a transfer in ownership. Take the first step today by talking to a professional advisor about succession planning.

About S+C Partners LLP

S+C Partners LLP
has the experience to
help you evaluate your
options and determine
the right succession
planning strategy for your
business. We can help you
get the process started
with an introductory
meeting scheduled at
your convenience.

S+C Partners LLP provides first-class assurance, taxation and advisory services to successful enterprises to support their financial commitments and minimize tax liabilities.

We carry out our mission by providing our clients with timely, top-notch professional services throughout the year. S+C has recruited, developed and trained a first-class client service team to respond on a timely basis to requests for a broad range of professional services.

Based in Mississauga, Ontario, S+C has operated with the same core values of client focus, trust, teamwork, and excellence for more than 20 years. Two years ago, the firm added social responsibility to its core values in recognition of the positive impact we strive to have on our environment and in our community.

Today, S+C is led by a number of Client Service Partners, who are recognized leaders and specialists in their field. Their professional designations include Chartered Accountant, Chartered Business Valuator, Trust & Estate Practitioner and Certified Financial Planner.

For more information on S+C Partners LLP, please call (905) 821-9215 or toll-free 1-866-965-1435 or visit us on the web at scpllp.com or email info@scpllp.com.