ADVISING A FAMILY BUSINESS

LIVE CHAT: QUESTIONS AND ANSWERS

INTRODUCTION

CPAs often find themselves in situations where they are advising a family business on crucial issues such as succession planning and complex family issues.

CPA Australia currently provides access to a number of resources on these issues in association with FINH.

This online chat was an opportunity to ask questions about issues you may be experiencing with clients in this area.

The expert responding to member questions was:

- David Harland CPA, Managing Director, FINH. David is an expert advisor to multigenerational family groups in business. David is a frequent and respected commentator in the sector and holds both national and international accreditation in the field of family advising and family wealth.

RESOURCES

- On demand webinar recording: Ownership, governance and family business issues
- INTHEBLACK article: five reasons why a family business fails
- INTHEBLACK article: six ways local firms can compete with global brands
- FINH article: breaking the cycle of family business failure
- FINH article: is it time to professionalise your family business?
- FINH article: the importance of innovation
- Video case study: Tabasco's secret sauce
- Library resource: family businesses – the essentials
- Library resource: family wars – classic conflicts in family business and how to deal with them
- Library resource: the dragon network – inside stories of the most successful Chinese family businesses
- FINH website

QUESTIONS AND ANSWERS

What is a "family business"? I have many clients who are family owned and operated but they do not (and I don't) refer to themselves as a family business. What are the benefits of calling them a family business rather than an SME?

There are many. Firstly there is a lot of research that shows marketing as a family business is beneficial because people trust family businesses. Why not leverage that? Being a family business is a competitive advantage in the market. Also why not take the opportunity to create an ongoing legacy by harnessing that familiness?

You have said in the article that that setting up family governance structures is very necessary but also faced by most family groups with extreme reluctance. If I have a client that I think needs to have formal family governance structures in place, how do I make starting that process more appealing to them?

It is sometimes difficult to know whether to encourage governance on the basis of hope or fear. Hope of creating a long-term legacy, hope of seeing others stepping up in the business and grow and innovate. Fear of a sudden health crisis with no contingency plan and the business crumbling, fear of still doing the same thing when you are 80 years of age but not by choice and fear of damaging family relationships over succession conflict.

I have a client who is 70 years of age. The business is going well. He has one son (50 years) working in the business and two children not working in the business. He has recently been widowed and any conversation I have with him about making a plan for the future and handing over some leadership is met with complete denial. His business is his life now more than ever, however his son is being increasingly disenfranchised and may well walk away. How do I approach this in a different way so that an effective transition can occur?

Some people will never start a succession journey and unfortunately as advisers there is not a lot we can do except gently encourage. Encourage him to include his son in the planning and decision making. There are resources for education of family businesses in the market which also may help.

Access to capital from other global family businesses sounds high risk. What measures are put in place for the investor and the local family business? And how much capital are we talking about?

Families providing capital to other families can be from the hundreds of thousands to many millions. We work closely with our U.S based alliance partners on providing patient capital to our clients and others and there is clear and well used risk management process that has been in place for 20 years.

Many of my clients are managing the division of their assets in the will we have worked on together. What is wrong with that?

That is OK if it is just assets and they have worked it out as a family. If the assets include a family business however, they need to start planning early. Too many times we hear "they can sort it out themselves when I'm gone" absolving all responsibility to others and increasing the chances of conflict.

What options are there & what issues need to be considered if the sole director of a small family company may have a terminal illness & has no real successors?

There aren't many options it seems except a sale or management buy out. It is a shame there are no successors around. I would be exploring both of those options with the client.

What are the most popular (and successful) exit strategies when you need to close down a family business?

The question I should ask you first is why would you want to shut the business down? If the owners are approaching retirement and have no-one to pass the business to, I assume that means that they have no one who wants to operate the business. This is distinct as to owning the business. I think the answer somehow lays in the previous question as the owners would want to extract the wealth they have created. You have indicated you are considering all options including sale externally and that you are particularly interested in wealth extraction strategies. It starts with identification of the likely buyers who are going to value the business the highest. All too often I find that it is the business owners who usually know that and that is mixed and varied. You would never dismiss competitors wanting to increase market share.

Extracting value depends on the size of the business (small business tax concession availability), franking credits etc. This is really a corporate finance exercise.

A question I normally encounter is when setting up a business structure there is always a fear if a child is named as a specified beneficiary, they get married, then there is a marriage break down. They want the child to be named for succession purposes but don't want the problems associated with a marriage break down. Is there a better way to approach this?

This is a major area and one that requires consideration of a number of perspectives. Clearly people do not get married for the short term. You often find that separations in families when there is a business can be caused by an inability to communicate about the complexities of running a business and a family together. In the context of planning and being thoughtful around "spouses" entering the family in business unit, it is suggested that you include them in some form of formalised education and communication strategy.

On the other hand when all else fails it is good to include in that education/communication strategy the introduction of Financial Agreements, also known as Pre-nups.

How do you know when's the best time to step aside and let someone else run the business? Are there certain signs or indicators of when is the optimal time?

There is no "best time" but it is good to be thinking about it and acknowledging it. We often refer to succession as transition. It is a process and happens best when there is good communication and over a period of time.

Are there certain steps that need to be completed when changing command in a family business?

If the business is small then the owners and governors are probably the same. The first step is to get everyone together to communicate and make a plan. This needs to be facilitated by a third party otherwise those issues of family/business/owner all become too blurred for the participants.

Regarding your comment that you work closely with American-based alliance partners on providing patient capital to clients and others, does that mean you are dealing with family business clients capital raising needs, whether as a result of identified succession or not? Are your US counterparts providing patient capital on a minority interest basis?

Yes your statements are correct and in fact we typically only deal with minority interests as when you really understand family business you know that the significant value is in the families continued control.

I also have clients concerned about "in-laws" and business assets. Is separating the ownership of assets away from the operation of the business an advisable strategy to commence succession planning?

As advisers we are drawn to the technical aspects of succession whereas typically the initial work around the human element is the first step. The fear of the "in-laws" almost becomes a self-fulfilling prophecy. Global research says that the inclusion of in-laws in the initial step is important and that the more family members you include in the conversation (we say "inside the tent") the more sustainable will be the outcomes.

Specifically your question needs me to ask you if you mean that simply because you are family and an operator doesn't that entitle you to ownership? You say that your client is prepared to hand over the day-to-day operation to the son, but not ready to fully "give him the farm" at the same time and that you are trying to determine the best ways to deal with these as separate issues. You have said that there is one other son, who is not working in the business and that there are some other assets to offset any inheritance issues. It is a farm over a couple of titles, which does give you some options.

The key here is that it is unlikely that Dad and the rest of the family have actually had a robust conversation around what each party thinks. Again we all jump to the financial/ownership issues and in farming operations this is a major challenge as it is possible that the economies of scale are just not there.

Ordinarily there needs to be consideration of the farm as part of the family capital and is it making the appropriate returns and are the operators being paid the appropriate returns for their labour.

The brother who grew up on the farm but does not work the farm probably has the same if not higher level of connectedness to the legacy that the farm represents.

An approach is to establish a formal family governance process to discuss these issues and work through just what is going to be sustainable for the future when considering not just the two boys but also possibly their spouses and their children. Sustainability means harmonious family relationships and financial capital that achieves appropriate returns necessary for financial sustainability in a growing family.

When a family business evolves and grows to a considerable size, would it be advisable to introduce non-family members to the Board so as to get a fresh perspective and inputs devoid of the emotional and politics of family members working in a family business?

Yes there is definitely a time and place for the introduction of independent members to the board of a family owned business.

Global research indicates that this is a key element to sustainability; all too often families in business do not recognise the need for the governance structure and process before the selection of the external directors. You would be better placed seeking an advisor that can help with this and then importantly identification of the skills required and then seek out those skills.

That contrasts with going out and getting Dad's local golfing partner who happens to be the local professional and thinking that this is a genuine attempt at this strategy.

When structuring a partnership/shareholder agreement are there clauses a family should also incorporate into the agreement which are different to the commercial agreements or norms?

Maybe but generally it is important to think of these things as separate. That is you can be family OR you can be family and a legal shareholder.

The other element is that because you are family you are likely to be what we refer to as an "Emotional Shareholder" because of your last name or the bonds created via the history of the family business.

It is important that the family communicate and have a formal structure to do this and document what they agree to, more commonly referred to as a family constitution.

How do you convince other employees (non family) that the succession plan agreed on by the family is for the best?

This is a process of change and human nature will naturally be suspicious of change. Time, "runs on the board", ongoing communication with staff will help. You need to let them know the benefits of keeping the business as a family legacy for everyone and that you want them to be part of that. No doubt they are valued. There are many documented examples and case studies of this and I can share with you after if you like.

If I believe my family business (property) is ready for external funding, even in the case where my family is only selling a portion, shouldn't I be worried about US equity providers interfering in the customary family business operations process? What is your experience in this regard, how can we tell if (for example your) US investors share the values of Australian family business?

I suppose the question is why does your family business want to sell? Liquidity for the exit of the outgoing generation (Liquidity)? De-risking the family capital? Or looking for growth capital as part of a "becoming global or larger strategy?

We are globally recognised as bringing capital to family groups firstly because that capital is from a family group that recognises the unique characteristics of families in business and importantly are patient and not looking for any quick turnaround and exit.

We would want to see that the family has commenced or well developed family governance processes and that the reasons for raising capital are strategically aligned between the business, its owners and both of these systems succession needs.

Our experiences have shown that US investors don't normally have the same values and have their own guidelines. This has a negative effect on the vendor Australian family, especially if they have been retained in the business to assist the new operators.

I think that this identifies as an example why the characteristics of the supplier of capital are important in a family business situation.

I wouldn't be too harsh on US investors and particularly those that have a genuine interest in the family retaining control and that are patient.

I think your investor doesn't sound like a family patient capital investor but more buy-out. I think you could give the same example for many nationals that invest in any asset across their boarder. The key is do they understand families in business and want to nurture that because they see it as a valuable part of the investment.

You have indicated that you think the issue is whether they understand the concepts of a family business and that it was treated by the purchaser as a buy-out.

This is a major cause for challenges. I recently had a large group in Sydney who sold a very large business to a Chinese company. The patriarch of that business thought he was making the right decision until after the sale proceeds were in the bank, the sons then said, “Why did we do it dad as this was our legacy and we will have to go a long way to replace such a good long term asset. We would have liked to expand globally and really kept things going.” A bit of an extreme case to make the point about the human element/capital and delving beyond financial success.

FOR HELP

Email CPA Australia: publicpractice@cpaaustralia.com.au

Email Kim Harland, Director Client Services, FINH: kharland@finh.com