



## **What Business Owners Should Consider When Crafting a Succession Plan**



**FIFTH THIRD BANK**

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For many business owners, their business is their largest asset. In many privately-owned businesses, the owner is the business—meaning it's important they ensure the business can run without them in the picture and they take steps to move the business in that direction prior to their exit.

When developing a succession plan and exit strategy from their company, business owners should keep a few things in mind—especially when consulting with an outside expert.

### How to Realize the Value in Exiting a Business

Before embarking on a succession plan for their company, business owners should think broadly about how they'll be transferring ownership and management of the business.

- **Selling the business to an outside third-party** involves just that: selling ownership of the business to an outside party. The goal, of course, is for the business owner to receive the maximum value possible from the sale.
- **Transferring ownership of the business to family members.** This could be your children or other members of your family. Transfer of ownership can be made via a sale, a gift or other method. A key consideration to think about here is how you'll realize value for your needs from this type of ownership transfer? You should also think about whether or not this is the best way to pass wealth onto the next generation. Keeping the business in the family is wonderful idea, but is this the best way to realize value from the business for you and your heirs?
- **Selling your interest to a co-owner of the business.** This entails transferring your ownership interest in the business to a co-owner or partner. Ideally, there is some sort of succession plan laid out, as well as being documented and funded, for this type of transfer well in advance of the need for it.
- **Selling the business to a key employee(s).** Over time you might recognize one or a few key employees are integral to the success of the business and more importantly are capable of running the business. This type of transfer takes careful planning to ensure a successful transition for all.

Each of these types of ownership transfers will have different financial structures and different financial implications for you upon exiting from the business.

Regardless of the exit strategy chosen, it's important to obtain an outside valuation of the business from an independent valuation professional. This will be the initial basis for a selling price and will have implications on any tax issues stemming from either a sale or an internal transfer of ownership.

## Seeing Value from Your Succession Plan

As a business owner, how will you realize value from your succession plan? This is not always as simple as it might sound.

- In the case of a sale to a third-party, will the sale be for all cash upfront? Will the payments be made in installments over a period of time? Will some or all of the payment be made in some form other than cash, for example stock or some other ownership interest in the acquiring company?
- If transferring ownership to co-owners or partners, how will the payments be structured and is there sufficient funding for the payments to you?
- How will a sale to key employees be funded? Do these employees have the capacity to secure outside financing? Will payments be made over time from profits from the business?
- If passing the business on to heirs, how will the owner be compensated if at all? Can the business support a series of payments over time?

Beyond the financial considerations discussed above, what is expected of the owner upon their exit from the business? Do the new owners want the owner to remain with the business for a period of time following the transaction to ensure a smooth transition with clients and for internal staff? This should all be spelled out as part of the transaction agreement. The owner should give thought to these issues in crafting their succession plan.

## Is the Business Ready to Operate Without You?

Regardless of what type of succession plan you choose, you should make sure that the business is ready to run without you long before exiting. Questions to consider are:

- Are the business financials clean and up to date?
- Are the company's systems up to date? Production, financial management, distribution, etc.?
- Will customers stay if you leave?

Many small businesses are all about the owner—they're the face of the business and often have a big say in everything. This might include manufacturing and distribution issues as well as being the main point of contact with customers.

Ensuring the business can function and prosper without the owner having a hand in everything is a good business practice for the company at any phase, but especially as you look toward exiting the business.

An outside buyer is interested in buying a growing business that can run independently of any involvement by the owner. While the owner may stay on or be involved during a transition period, they are ultimately looking at what the company

can be long after the owner is out of the picture.

You want to be sure the business runs like a business, which can entail a number of changes, including:

- **Ensure the business' financials are clean.** It's important to ensure that the financial statements and internal accounting systems are all in line with the appropriate regulations and accounting principles. Ensure that your firm's outside accountant is capable and can assist the company in this initiative—the new owner won't want to encounter any financial surprises.
- **Install modern accounting and business systems.** Your company should have modern accounting and business systems in place. The internal accounting system should help facilitate internal financial controls and make your company's outside accountant's job easier. Other systems such as those for production, inventory, client/customer management, billing/tracking time and others should be up-to-date and appropriate for your company's type of business.
- **External customer relationships** should be able to be managed by others in the firm. It's perfectly natural that when the business was first started that the owner's personal relationships were key in building a customer or client base, especially for a professional services firm or a local manufacturer or distributor. However, it's important to build the organizational capabilities to have others besides the owner manage these relationships, as well as evolve relationships to ensure that they are with the company as a whole.

Overall, it's crucial to ensure that the business is equipped with a team of professionals in place to manage the company's financials, the delivery of the company's product or service and the relationship with the business' clients and customers. Not only is this helpful in terms of selling the company or transferring ownership, but these are all good practices for the business as a going concern, regardless of when the owner intends to exit.

Depending on the size and the nature of the company, the owner might consider hiring an outside manager to run all or part of the business on a day-to-day basis while they are still engaged in the business.

In a similar vein, if the succession plan entails transferring or selling the business to heirs or other family members, co-owners or key employees it's a good idea for the owner to begin to step back and allow those who will eventually be running the company to assume increasing levels of responsibility.

This will give the owner an insight as to whether these individuals are capable of running the company upon his or her exit from the business and help them determine if their succession plans need to be revised. This can also provide additional management expertise in the event that they do measure up to the challenge prior to the owner's departure.

## Determine Your Exit Strategy

You should ask yourself a few questions to consider when determining your exit strategy:

- Are there family members who are willing and able to run the business?
  - » If you're planning to leave the business to family, which family members will benefit? If there is only one family member besides yourself involved in the business, this is an easy decision. However, if there are a number of family members involved or interested in the business this could easily become a divisive issue within the family.
- Are there internal non-family member managers who are ready to step up?
- If not, is the business ready to command its highest potential value in the marketplace?

## Tax and Estate Planning Considerations

Tax and estate planning considerations are a complex area, so it's advisable to work with qualified legal, tax and financial professionals to ensure that all bases are covered.

As mentioned previously, an outside valuation of the business is important. Also, the structure of the sale or transfer can be critical in determining the estate tax treatment.

Business owners should consult with a qualified tax and estate planning professionals to help ensure that the exit transaction is structured in the best possible way to minimize your personal income tax liability and to minimize any estate tax implications for your family.

These can be very complex transactions, especially if assets like equipment, real estate and other hard assets are involved. In a service business, the value of any intellectual property must also be considered.

## Ensuring Financial and Retirement Needs are Addressed

Prior to executing your exit strategy, it's a good idea to address your own financial needs with a financial professional.

Establishing and funding a business retirement plan should be a priority for you well before any thoughts of exiting the business. Whether a 401(k) or another type of retirement plan, contributing to a retirement plan is a solid way for the business owner to save for their own retirement needs, contributions offer ongoing tax benefits and a retirement plan is often cited as top recruitment and retention policy for employees. In some cases, the plan can be structured to allow the owner to

contribute an even greater percentage of any contributions made by the business to themselves.

Depending on the nature of your business and its cash flow situation, a defined benefit pension plan might be an alternative beyond a 401(k) as a means to put away even more money for the owner.

Saving via a retirement plan allows you to accumulate a retirement nest egg regardless of whatever value they might realize from their exit from the business.

It's important to have proper insurance in place in case the transfer of the business is due to death or disability. These types of policies can fund buy-sell arrangements if there are business partners involved or provide a level of value in the event the business must be sold at a lower than desired value. These policies can provide liquidity to your family if needed in those situations.

Ideally, you'll do a lot of planning both for the business and your own personal situation as part of the succession planning process.

## Summary

Creating a proper succession plan is a crucial financial planning issue for business owners.

Working with a financial advisor who understands the issues faced by business owners is critical. The advisor, along with tax and legal professionals, can help their business owner clients realize the maximum benefit from their years of hard work building the business, which is often the client's largest asset. The right financial advisor can act as the financial quarterback throughout the planning and execution of the business owner's succession plan, providing advice and guidance during all phases of the process.



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