

Project managing the contingency planning needs of SME clients

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Most business owners protect the assets on their balance sheet such as plant, premises and equipment, but a business has something far more valuable than physical or financial assets. The most important asset a business has is its people. It is the human values of knowledge, skill, experience, creativity and leadership that enables a business to prosper and grow.

Without key individuals, most small to medium sized businesses (SMEs) would be unlikely to reach their full potential. In fact, the exit of a key person or owner could cause serious financial stress or worse still, may cause the business to fail.

Given this, SME's need to consider the value of having a documented business contingency plan which addresses both the voluntary and involuntary exit of an owner or key person from the business.

Defining the SME market

Key characteristics of this segment include:

- significant debts and/or liabilities – often backed by personal guarantees
- businesses owners relying on the equity within their business to provide for their retirement
- business owners with a number of key employees who play a critical role in the operation and success of the business
- one key principal dealing with creditors and/or the bank
- key customer relationships managed by one or two principals or individuals within the business

What is the size of the SME market?

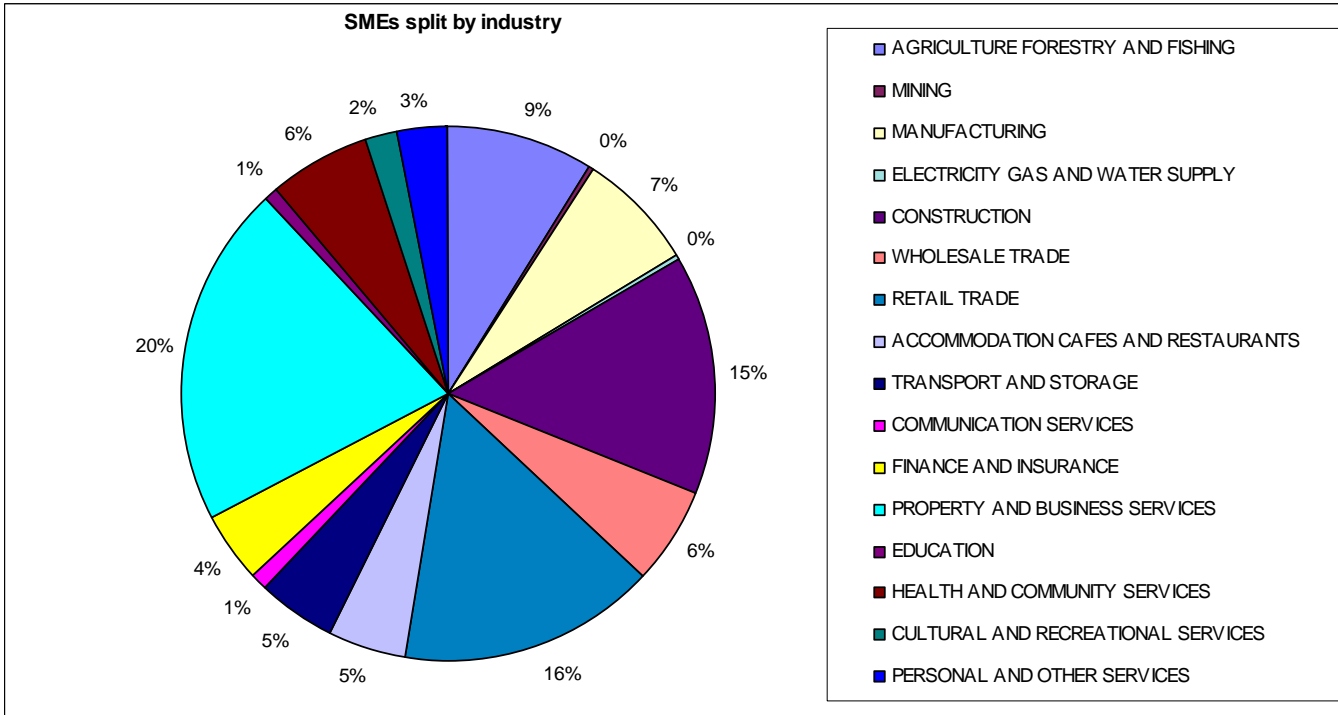
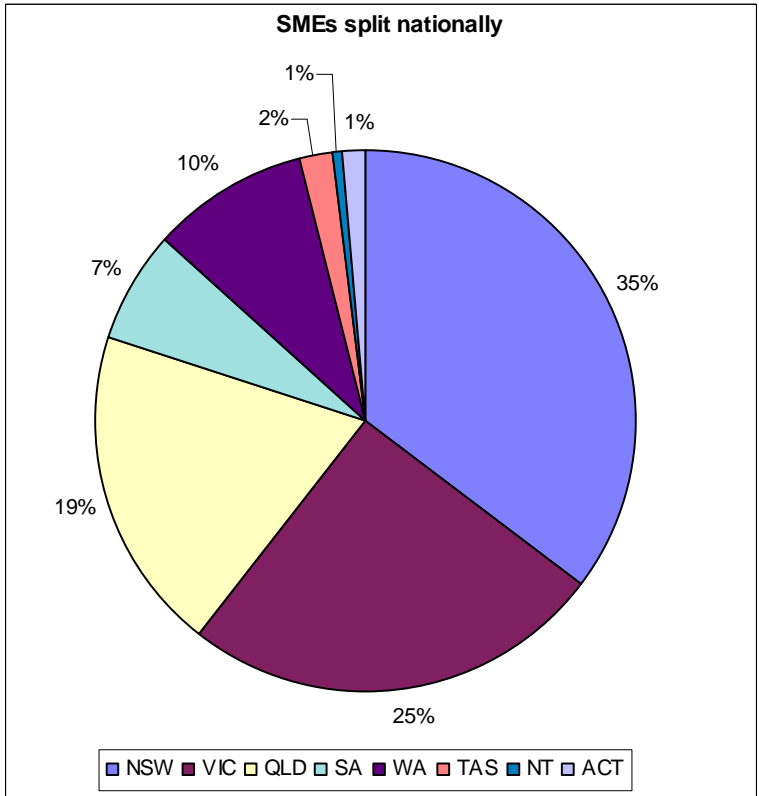
Research shows that the SME market is diverse and ever changing, which is clearly highlighted by the fact that each year we see a number of new 'start up' businesses formed, while many others expand as a result of the implementation of different growth strategies. On the flip side there are an equally high number of businesses which fail due to a variety of different factors and circumstances.

According to the 2006 Australian census, there were a total of 801,784 'small to medium sized enterprises' operating across Australia. These SMEs can be broken down into the following categories:

- 494,196 (62%) businesses with 1 to 4 employees
- 227,373 (27%) businesses with 5 to 19 employees
- 80,215 (10%) with 20 to 199 employees

The size of the SME sector dwarfs the large business sector, with only 5,797 (less than 1%) employing more than 200 employees.

Over 50% of SME businesses are in property and business services, retail trade and construction. Geographically, SME businesses are located across Australia with 35% being based in regional centres.



What are SME owners thinking?

For the majority of SME business owners their key focus often revolves around running the business on a day to day basis. In most circumstances the business itself is their most significant asset and is often seen as their superannuation nest egg. It therefore defies logic that so few have taken the step to construct and document a robust business contingency plan which provides certainty and peace of mind for all parties.

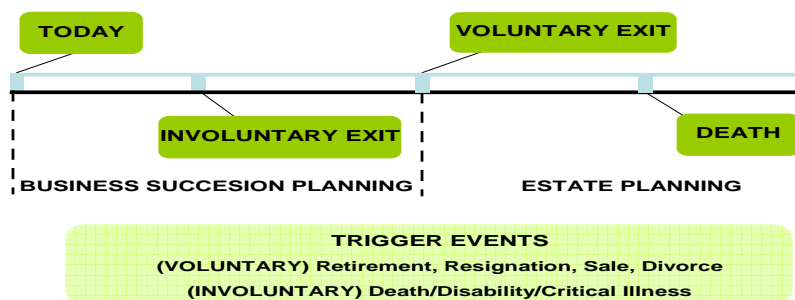
In the *KPMG and Family Business Australia Survey of Family Businesses 2008*, it was revealed that some of the challenges facing SMEs today include growing profitability (61%), government regulation (46%) and economic stability (48%). A lack of focus on business succession planning and protection across the segment highlights the need for advisers in the financial services area to educate small business owners about the real risks faced by not having a well constructed business contingency plan.

Another recent survey conducted by *Business Health*, an independent advisory group, indicated that the SME demographic is time poor and more demanding while also having an expectation that financial advisers develop a unique service offering which is tailored specifically to the segment. The survey went on to highlight that the financial adviser's service offering must be underpinned by a clear process offering a broad range of solutions while also being able to provide access to other industry professionals (Accountants, Lawyers, and General Insurance Brokers) where necessary.

It is clear from these findings that financial advisers have a significant role to play in 'project managing' the business succession planning and protection needs of SME business owners.

Exit strategies

Most SME owners expect to exit their business on their terms via a voluntary exit scenario such as retirement or resignation. However, an involuntary exit due to premature death, disability or critical illness also needs to be considered as part of a comprehensive business succession and protection plan. The critical objective in either a voluntary or involuntary situation is that transfer of equity occurs in a timely manner and that sufficient funds are available to facilitate this transfer, thus, highlighting the importance of having a well documented business succession and protection plan which clearly addresses both the voluntary and involuntary exit strategies from a business.

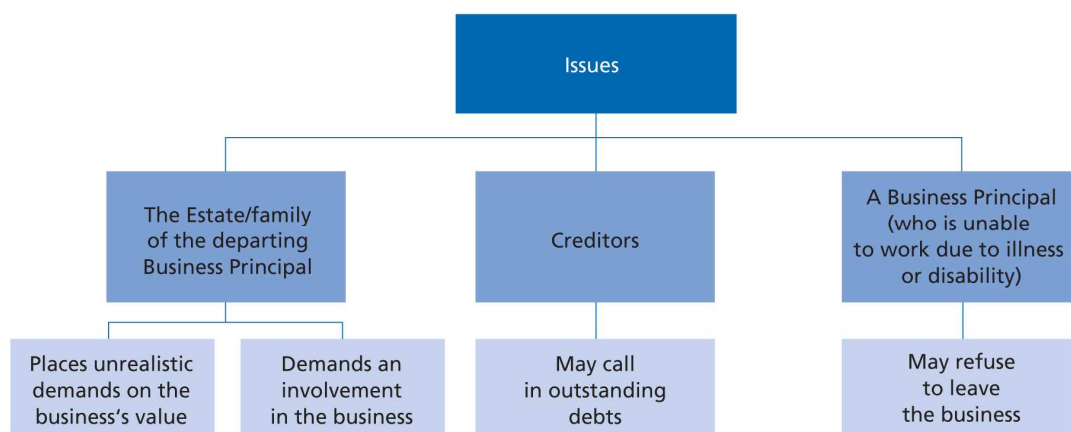


What can advisers do to help an SME client?

More and more business owners are seeking solutions from financial advisers in addressing the catastrophic scenarios their business would face if they, a business partner or key employee, were to become ill, incapacitated or even pass away. Advisers who embrace the concept of 'project management' in this area offer an important value proposition to clients in the SME segment.

Clearly, the SME sector represents a huge opportunity for financial advisers to address the contingency planning needs of SME business owners. Financial advisers who take the time to understand the very specific needs of SMEs will be in a better position to assist their customers, as well as potentially realising further growth opportunities.

What are the consequences of not having a business protection plan?



In the event that a business principal dies, becomes critically ill or disabled, there may be serious disruption to the day-to-day activities of the business which, in turn, may lead to dire consequences for the business in respect of its viability and longevity. Some of the issues that may arise include:

- The estate or family of a departing business principal may make unrealistic financial demands on the business, or demand personal involvement in the business. This may result in a deterioration of the value of the business and the lifestyle of the remaining business owners.
- Creditors may call in outstanding debts. This can place enormous financial strain on the business along with the remaining owners. If the business cannot meet the loan obligations, the remaining business principals may be required to cover the shortfall. If they are unable to do this the business may need to sell valuable business assets to extinguish the liability or be wound up.
- A business principal who is unable to work due to illness or disability may refuse to leave the business. Apart from placing extra strain on the other business principals, this may place unnecessary financial strain on the business, i.e. the business may be required to support a principal that is not adding value to the bottom line. Once again, this may have the flow on effect of significantly devaluing the business, resulting in liquidation and subsequent closure.

Therefore, it is critical that a business has a coordinated contingency plan which is underpinned by the appropriate legal agreements to ensure that if something happens to trigger the exit of an owner - the effect on the remaining business principals is minimised, otherwise it may lead to a deterioration of living standards, decrease in business value or possible closure of the business.

How can financial advisers assist an SME?

The core objective of most business contingency plans is to facilitate an orderly, funded exit strategy, of one or more owners. The role of the financial adviser is to consider and implement a funding solution which takes into consideration a variety of different options including insurance.

In many cases the business forms the major asset of an owner's overall personal financial position. The need to protect the business and family interests against catastrophe is vital. It is important for owners to ensure the necessary funding mechanism is in place, to buy-out another owner's share in the event of certain trigger events, such as a business owner being unable to continue working as a consequence of a critical illness or disability.

In conjunction with an experienced adviser, business owners can develop a plan to protect against the serious financial consequences of illness or premature death. The funding solution for each owner typically will cover the value of their equity in the business as well as considering transfer costs such as CGT liabilities.

A well-prepared and exhaustive business protection plan will also cover the overall financial impact of the departure of a proprietor especially with respect to business debt that is often backed by personal guarantees.

Such guarantees are not extinguished upon the death or departure from the business of an owner, therefore making it critically important to ensure these debts are paid out. If they are not, the death or departure of a guarantor may actually give rise to the guarantees being called in.

By preparing and regularly reviewing business succession and protection plans, business owners can discuss their intentions and preferences regarding the business on an ongoing basis. Those who take the necessary steps to address these issues often have an increased level of certainty and peace of mind as a result of documenting these plans and strategies.

The benefits of a coordinated business succession and protection plan

A well-structured business succession and protection plan can assist a business by:

- enabling the surviving business principal(s) to buy out the financial interest of a deceased business principal
- enable a principal(s) to buy out the financial interest of a business principal who is permanently unable to work due to illness or injury
- replace lost profit and cover ongoing business expenses
- repay business debts as and when they fall due, should a business owner be unable to work due to illness or injury
- maintain the credit standing of the business
- maintain the business cash flow to cover the cost of replacing and training a new key person
- keep the business viable until an appropriate buyer can be found

The team of professionals - Financial Adviser, Accountant and Lawyer

The reality is that no one professional has the ability to address all aspects of an SME's business succession and protection needs, however, by working together in a co-ordinated manner they all play an important role in bringing the plan together. Typically the financial adviser coordinates the entire process in a 'project management' capacity.

Let's consider the areas which need to be addressed as part of a well rounded business succession and protection plan.

Accounting

A proper valuation of all the different entities (the organisational structure) that make up the business, is critical to ensure that a fair value is established and subsequently paid, for the equity of a departing owner. In addition the valuation process needs to consider potential tax liabilities such as Capital Gains Tax (CGT) and ensure appropriate provisions are built into the contingency plan.

Legal

The overarching legal agreement is required to reflect the wishes and needs of all the parties to the business. This agreement ensures certainty for all parties while also clearly documenting how equity is to be transferred and how much is to be paid for that equity when a proprietor departs. This is a highly specialised area which requires the attention of a business succession and estate planning expert.

Financial

The funding solution underpins the agreement and ideally matches the valuation including any potential tax liabilities such as CGT calculated by the accountant. By using insurance as part of the financial contingency plan the business can ensure the entire amount will be available within a reasonable period of time after the death, total and permanent disability or critical illness of a business principal occurs. Other funding solutions may be considered as part of the plan depending upon the circumstances of the individuals and the overall business however insurance funding is often seen to be the most cost effective way to fund involuntary exits.

What areas should be considered by financial advisers?

Some of the points which need to be considered by financial advisers when discussing business succession and protection plans with SME clients are outlined below.

Why should SMEs consider insurance as part of the business contingency plan?

Unlike a traditional sale in the normal course of business, the continuing proprietor(s) may be unable to raise the necessary finance to buy the outgoing proprietor's equity upon premature death, disability or critical illness. This problem is compounded by the unexpected nature and timing of these events. In an attempt to address this uncertainty, insurance should be considered as part of the funding solution for most business succession and protection plans, due to the fact that it can generally provide the necessary funds in a timely and efficient manner.

Who should pay the premiums?

There is no simple answer as to who should pay the insurance premiums and how much they should pay. The age and health of most business owners varies, and if it is possible to obtain insurance cover, the cost might differ considerably. Often the cost is simply shared, equally (between owners). It is likely to be a matter of the owners satisfying themselves that the negotiated outcome is fair and reasonable. This may involve the accountant to help identify the best way to manage within the business accounts. This process should just reinforce the fact that the contingency plan is a critical part of life for all SME businesses and merely reflects a normal business expense that protects the interests of all parties in much the same way as they approach their general insurance portfolio which protects the physical assets of the business.

Who should own the insurance policies?

There is no single prescribed method which will be appropriate in all circumstances. Ultimately the purpose of putting a plan in place is to ensure certainty, which is often achieved by having the policies self-owned and subsequently underpinned by the necessary legal agreements. Other options which can be considered include superannuation owned, trust owned, company owned or cross owned. Each method has its own pros and cons which need to be assessed on a case by case basis.

Case study in action

Let's review the following case study and see what happens to an SME business in the absence of a well constructed and documented business succession and protection plan.

Paul is a 55-year-old lawyer who is married to Kylie and they have two children. Paul is in partnership with his good friend, Doug, who is 32 years old and recently married. Paul and Doug are the partners in Eureka Legal Advice. Doug specialises in administration and staffing. Paul has the technical expertise on the client facing side of the business. Together, they make a competitive business combination. Through seven years of hard work, the business is now worth \$1.1 million.

Paul suffers a stroke and cannot continue working. Months pass and the business begins to suffer financially. Doug cannot afford to hire someone to replace Paul, as Paul is still drawing a salary out of Eureka Legal Advice. Doug wants to buy out Paul's stake in the business but they cannot agree on the value of the business. In addition, Doug is unsure how to fund the purchase as all of his personal property is already held by the bank to secure existing business debt.

Paul subsequently passes away, leaving all his assets (including his interest in Eureka Legal Advice) to his wife. Following is a break down of the business:

- Eureka Legal Advice borrowed \$230,000 to purchase new premises and the bank's overdraft is running at \$23,000. Both debts were guaranteed by Paul and Doug. Paul's death triggered an automatic default of both debts. The bank manager required Doug to repay or renegotiate the loan and asked whether Kylie would guarantee the loan.
- The firm has lost one of its biggest assets – Paul's years of legal and business knowledge. Doug has to immediately find someone who could fill that role, as well as finding the salary necessary to attract the right candidate.
- Kylie could not help run Eureka Legal Advice. Kylie's once good relationship with Doug is souring over the dispute as to what should happen to the practice and Paul's equity.

Doug is eventually able to re-finance the two loans at a higher interest rate. He employs a lawyer on a salary of \$80,000 a year.

Doug is forced to take on further debt to keep the business afloat. In desperation, Doug tries to sell his share of the business. The offers are only a fraction of what the business was worth before Paul suffered the stroke.

For Doug and Paul, the business was not only their job but their life and financial security. The business was to be their retirement nest egg. Now it won't even provide their families with a roof over their heads.

By planning ahead and arranging a business succession and protection plan SME clients are able to avoid a situation similar to that outlined in the case study. However, if these steps are not taken then this outcome may actually become a reality.

Aviva SME Professionals Program

Earlier this year, Aviva piloted an adviser education program which focuses on the SME market. This program aims to equip advisers with the knowledge and skills to deliver market leading advice to SMEs in Australia. The key focus of the SME program is on process rather than product.

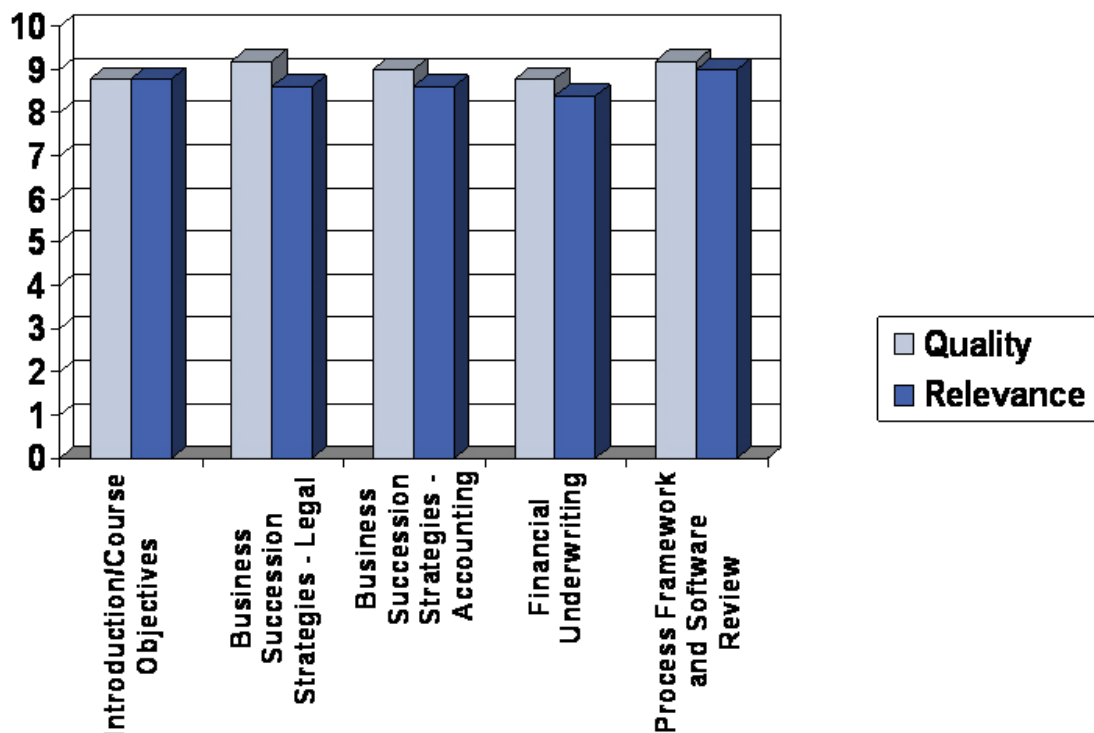
Aviva has worked with a number of external technical experts in building this program across the key areas of:

- Legal
- Accounting
- SME consulting/advice

Upon completion of the two-day program, advisers are provided with a framework that will enable them to 'project manage' the end to end process of advice solutions for their SME clients, with key value adds including:

- Centre of Influence development and support
- access to leading SME industry specialists
- 'cutting edge' adviser support tools

Below is how advisers rated each session of the program.



Adviser feedback on Aviva's SME Professionals Program has been overwhelming with the two day course rated by advisers an average of 9.3 out of a possible 10.

Advisers rated the business succession strategies and maximising centre of influence sessions as the most valuable elements of the program.

This program has also been accredited by the FPA and awarded 12 CPD points.

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About the author

Russell Hannah is the National Distribution Development Manager (Protection) at Aviva. Russell is responsible for growing Aviva's protection sales as well as providing feedback and input into product, service and technology design and innovation in the Protection business.

Russell has positioned himself, through education, training and experience, as a subject matter expert in the areas of estate planning and business risk insurance.

Russell previously worked at ING where he held the roles of National Key Account Manager and Senior Risk Business Development Manager.

In 2007, Russell was awarded Money Management/Tribeca Business Development Manager of the Year.