BMO Wealth Institute™

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Are Your Business and Personal Finances on Solid Ground?

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

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Are Your Business and Personal Finances on Solid Ground?

Owners of a private business constantly face the difficult challenge of balancing the needs of their business with the needs of their family. There are financial and time trade-offs that business owners must constantly make as they strive to generate predictable business earnings and growth that can be used to help them achieve their personal financial goals. This paper will focus on opportunities and ideas to better integrate personal goals with the needs of a business throughout the various stages of the business life cycle and the business owner's life cycle.

Starting and operating a business is not for everyone. Being your own boss requires a huge commitment to the business, and this will mean a significant investment of both time and effort on an ongoing basis. Lasting success also requires business specific knowledge, real passion, and the ability to take smart, calculated risks in order to get ahead and stay ahead financially. With so much time and effort invested in the business, there is often less time available to meet personal needs and the needs of the business owner's family.

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But there are benefits to being your own boss that 2.7 million self-employed Canadians have chosen to pursue. Owning and running a business provides the independence to make decisions, the opportunity to leverage passion for business ideas, and the ability to control the amount of income that it is possible to earn each year.

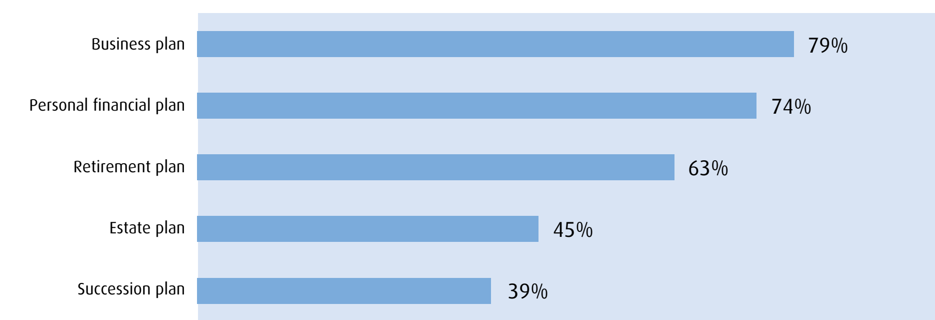
Even though it may be possible to withdraw regular profits to support personal needs, a business can represent a large illiquid asset for the business owner. Strong financial management is essential to ensure long-term business stability and, ultimately, the growth of personal wealth over a lifetime. Both the business and the business owner can benefit from timely financial and wealth planning guidance from trusted professionals.

Both the business and personal situation of a business owner can benefit from timely financial and wealth planning guidance.

Recently, a survey was conducted by the BMO Wealth Institute that explored how business owners balance the links and the trade-offs between their families and their businesses. Overall, the survey indicated that business owners consider both business and personal planning to be important, with 79% of respondents indicating that they have a business plan, 74% noting that they have a personal financial plan, and 63% reporting that they have a retirement plan. Of all the plans noted, 60% were formally prepared.

Business owners consider both business and personal planning to be important.

Incidence of planning amongst business owners

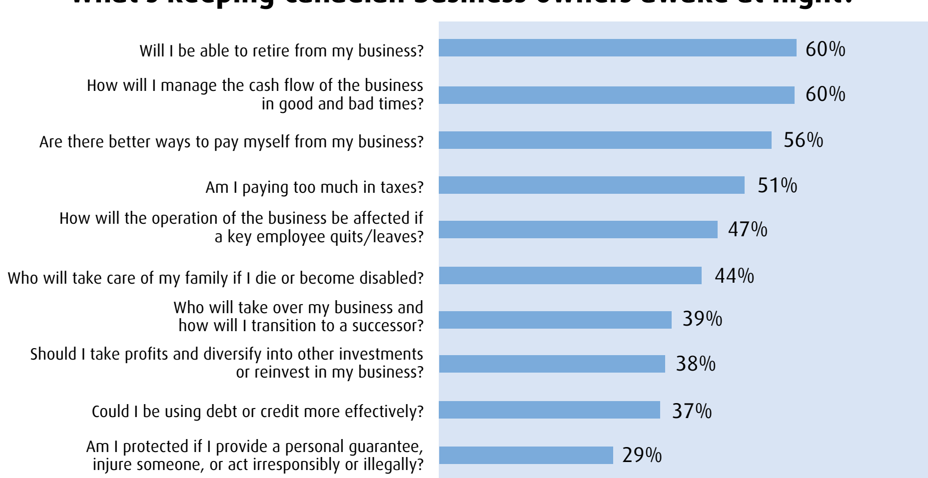


Source: BMO Wealth Institute survey by Research Now, September 2013.

Each business owner faces unique financial issues; however, there are some common threads that intertwine the business and personal concerns of the business owner. A clear example of the linkages was noted by 60% of the business owners who participated in the BMO Wealth Institute survey. When asked "What keeps you up at night?" the top concern noted by survey respondents was being able to retire from their business.

Being able to retire from their business a top concern among business owners.

What's keeping Canadian business owners awake at night?



Source: BMO Wealth Institute survey by Research Now, September 2013

The Business Life Cycle

In general terms, the phases of the business life cycle are start-up, growth, established, expansion, maturity, and finally succession. As businesses and their owners recognize and respond to the need for the "reinvention" of their businesses, they will cycle through these phases with the introduction of new products, services, capabilities, or markets. The issues and needs at each phase of the business life cycle affect both the business and the owner personally.

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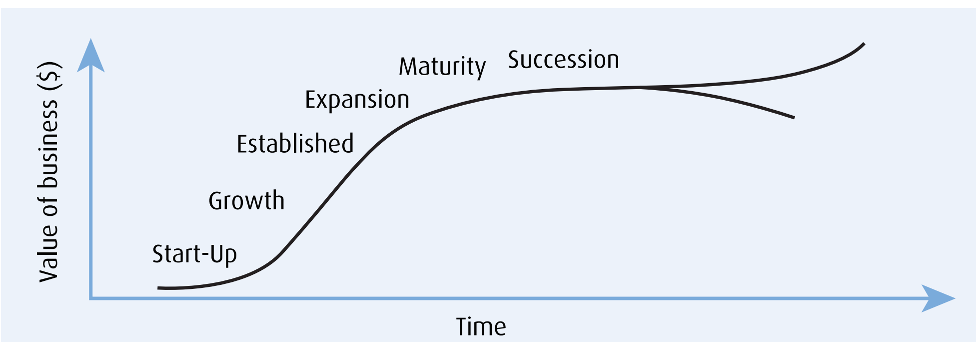
Typical Business Phase Chart

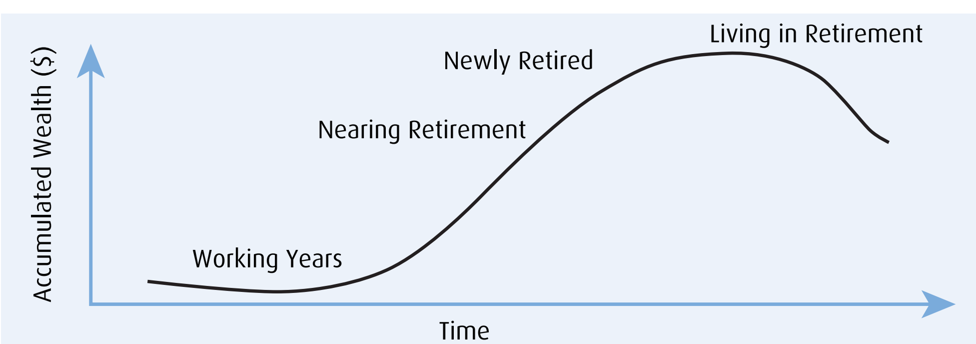


The Personal Life Cycle

Business owners also have a similar life cycle for their personal and family situations. This life cycle includes the following phases: working years (career building and then wealth accumulation), nearing retirement, newly retired, and finally living in retirement. The phases have some overlap with the business life cycle, although every business owner's situation is unique. There may also be situations where the phases don't line up.

The personal life cycle may have some overlap with the business life cycle, although every business owner's situation is unique.

Personal Life Cycle



In today's modern families, it is common for individuals to cycle back through stages or straddle two stages, because of second or third marriages; multiple sets of children, perhaps with a significant age gap, arising from subsequent marriages; or common-law arrangements taking new prominence. Regardless of the reasons, it is important to understand that personal priorities are distinctive for each individual.

Business start-ups are on the rise in Canada. According to another survey conducted by BMO, starting a business after graduation is a very popular option for Canadian post-secondary students. More students plan to start their own business (46% nationally), because they are not confident they will find employment in their own field of studies after graduation (only 29% were confident).

Business start-ups are on the rise in Canada.

Nahla, a university student with a master of arts degree, is an example of the rise of entrepreneurial graduates. She graduated last year and, like many of her peers, could not find employment in her field. She took the opportunity to expand on a part-time business she started while in her undergraduate years that provides fitness training and coaching to aspiring competitive figure skaters. Using all of her background knowledge and the relationships built over the years she herself was a competitive skater, Nahla has been able to establish herself with two of her city's influential skating clubs and has taken on a number of promising clients.

There is also a rise in the number of baby boomers opening up businesses as a precursor to full retirement (or as an alternative to retiring altogether). A study conducted by BMO Financial Group showed that two in five Canadians planned to start their own business after they reach the traditional retirement age of 65. A much larger percentage (81%) also indicated that they planned to work during their retirement years. Some of the reasons cited include the need for additional income, a desire to stay sharp and mentally focused, and the expectation that their employment could be an enjoyable hobby for them.

2 in 5
Canadians planned to start their own business after they reach the traditional retirement age of 65.

For business owners, whatever their personal life stage, a common methodology for planning is to overlay their personal life cycle on their business's life cycle, to gain perspective on the unique needs arising at various crossing points. Basically, the personal life cycle diagram is superimposed on the business phase chart.

Business Plans and Financial Plans

Business plans and financial plans have very different focuses, but for the business owner it is very important that the two plans work together. At its most basic, a business plan documents the steps that the business will take to earn profits. Initially, these profits are reinvested to help grow the business and reduce the debt that was initially incurred. Later, these profits may be withdrawn by business owners and used to achieve personal goals that are important to them and their families. These personal goals may include plans for funding retirement or children's educational expenses.

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Start-up

Business Considerations

Businesses in the start-up phase tend to have high capital investment needs relative to the amount of revenue that the business is able to earn. Much of what business owners contribute to their newly started business is in the form of "sweat equity," for which they receive little, if any, remuneration. Access to investment capital and the reinvestment of any revenue earned back into the business may compete with the need for cash flow to support personal and family needs. This leads to the start-up phase being a trying time emotionally for many business owners, as there is typically a considerable investment by the owner and little financial benefit in return.

Access to investment capital and reinvestment of any revenue earned back into the business may compete with the need for cash flow to support personal and family needs.

Personal Considerations

Businesses can be started at any point in a person's life cycle. In the past, there was a greater likelihood of starting a business early in one's working years. With the change in employment opportunities and the downsizing that has occurred over the last several years due to the economy, an increasing number of baby boomers are now starting businesses later in their working years, and even in their pre-retirement years.

For example, at the age of 48, Tyler lost his role as head of development when the technology firm he was employed by was purchased by a larger competitor. After several months of unsuccessfully looking for a similar job to support his growing family, he decided instead to start his own business, using an idea that he had been thinking about for the past few years. His novel ideas about incorporating high-resolution graphics and first-person role-playing simulations into on-line safety training programs were an immediate hit with a number of industrial clients. Since his layoff two years ago, he has expanded his business and hired a number of programmers and designers to meet the increased demand from his clients, and he is earning more as a business owner than he ever did as an employee.

Increasing number of baby boomers starting their businesses later in their working years, and even into their pre-retirement years.

Depending on their level of savings, retirement assets, and pensions that have accumulated to date, new baby boomer business owners may have the capital needed to start their new businesses. While capital to start the business is very important, so is meeting the ongoing needs of the new business owner's family. In addition to having the cash flow to meet ongoing expenses such as groceries, utilities, and transportation costs, business owners can consider allocating funds to reduce the personal risks that they face. Health-related risks that can be mitigated through the use of insurance include the risk of becoming disabled, suffering a critical illness, or passing away. Insurance can provide the funding necessary to protect the business owner's family if any of these events occur.

Incorporating a business, rather than running the business as an unincorporated sole proprietorship, is another method that can be used to help limit some of the risks of business ownership. In many cases, borrowing for the purpose of funding businesses will require a personal guarantee, which will reduce some of the potential benefits of incorporation. The survey indicated that incorporation is a popular option, with 71% of the business owners surveyed reporting that their businesses are incorporated.

71%
of business owners have incorporated their business.

Growth

Business Considerations

During the growth phase there is still a requirement for a high level of capital to be invested in the business. Attracting and hiring a strong team of employees to grow the business is also a key challenge during this phase. Money is typically spent faster than it is taken in. Payables can increase quickly, and accounts receivable can take time to be collected.

In order to grow the business, the owner also has to learn to delegate and trust the team of employees that has been hired. This can be a challenge, because in the start-up phase entrepreneurs become accustomed to doing many tasks on their own, due to their know-how and need. As the business grows, needs change, and to grow effectively, educating the employee team and delegating work to them becomes essential.

Personal Considerations

During this phase, business owners will be in the working years of their personal life cycle. Business owners who started their businesses early in their careers will likely have additional family responsibilities that come with having a younger family. These may include the costs of a home mortgage, raising a family, and saving for future education needs. Business owners who are embarking on a second career later in their working years may also have these concerns, especially if they still have younger dependants at home, or are still supporting their children as they complete their post-secondary education.

A financial plan helps align the income generating ability of the business with the various needs of the family.

With these many personal and family needs, consideration has to be given to having a financial plan that helps to align the income-generating ability of the business with the various needs of the family. Near the top of the list of priorities should be saving for long-term needs, including retirement. Savings vehicles such as RRSPs and individual pension plans (IPPs) provide tax advantages at the time of contributing funds that will be accumulated to meet future needs. The survey showed that 82% of business owners planned to use their RRSPs to help fund their retirement, while 24% were planning to use IPPs.

Insurance also plays a key role, as it can be used to replace family income in the event of an unforeseen illness, disability, or accident. Policies can be purchased that help meet the needs of the business as well, such as a policy that will continue to pay business overhead costs for a period in which the business owner is unable to work.

Established

Business Considerations

Getting to the established phase of a business is quite an accomplishment for many business owners, and one that should be celebrated. According to research by the Canadian Federation of Independent Business, many small and medium-sized businesses do not survive to the five-year mark. For businesses employing under 50 employees, the survival rate is about 70%. For larger private businesses with up to 250 employees, survival to the five-year mark was achieved less than 60% of the time. More recently, Canadian Business magazine notes that less than half of new businesses started in Canada will survive five years.

To learn more about why businesses fail, click here **canadianbusiness.com/business-strategy/10-reasons-why-businesses-fail/**

Business owners must constantly monitor the environment to ensure that threats and opportunities are considered as they regularly review and update their business plans. These threats can include many factors, including increased competition, growing too quickly, not having a solid value proposition, and weakness in the economy.

Another challenge for established businesses is attracting, rewarding, and retaining key staff. Key staff create a tremendous amount of value for the company, and a reward system helps to ensure staff retention and prevent staff from departing to work for competitors or to start their own businesses.

Personal Considerations

At this point, established businesses should be able to start earning larger profits that can be used both to expand the business and to provide more income for the owner's personal purposes. As in the growth phase, there are often significant personal expenses and risks that business owners and their families face.

With a number of employees on the company payroll, group insurance might be considered, to help to attract and retain staff. As an employee, the business owner would be able to participate as well.

As the company has grown in size and value, there may be an opportunity to initiate tax-planning measures, such as the introduction of a holding company that can be used to help retain excess profits generated from the business or to facilitate income splitting with certain family members. Many business owners in the survey have initiated tax-planning measures, including implementing a more robust corporate structure (58%), multiple wills (34%), and trusts (29%).

A holding company can be used to help retain excess profits generated from the business or to facilitate income splitting with certain family members.

Expansion

Business Considerations

In order to survive in a competitive and changing business environment, the ability to change and react to threats and opportunities is key. One of the most important changes is the decision to expand. Timing an expansion is very important, as many key factors have to line up, including the strength of the business model and company processes, customer demand, financial strength, and the quality of the employee team. Deficiencies in any of these areas can seriously challenge a previously healthy business.

Timing an expansion is very important as many key factors have to line up.

Two of the expansion paths many businesses most frequently choose are entering new markets with existing product lines and expanding into new product lines. In both cases, access to capital to finance the growth is key, as money has to be spent in order to grow. The risks of entering new markets also have to be managed. There will be new and different competitors, and new laws and regulations to comply with.

Personal Considerations

Depending on the scale of the intended business expansion, internally generated funds from retained profits and outside borrowing will often both be required. This may, for some time, limit the amount of income that the business owner can draw from the business, especially if lenders impose covenants on the business while the loans are outstanding. For this reason, expansion should be well planned, with a clearly planned payback on the investment in a reasonable period of time.

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Maturity

Business Considerations

A mature business has tremendous advantages and tremendous disadvantages. On the plus side, the business is likely be at a point where it runs itself. Long-term staff know what to do, and things typically run quite easily. On the negative side, there can be significant risk from local or foreign competition, because they may recognize and seize market opportunities.

A further risk for businesses in a mature phase is obsolescence, if the business has reached a point where no further innovation or evolution is planned by the owner. Business service centres, for instance, have been facing increased challenges to their survival, given the rapid pace of technological innovation, and with changing tastes affecting consumer demand. The cost of technology has come down so much over the past few years that it has become easier to bring services in-house that were previously only affordable through business service centres. Another example of an industry that has declined in recent years is furniture repair and reupholstery. Changing tastes and the low cost of quick-assembly furniture have lessened the demand for classic furniture that has to be maintained and repaired.

A risk for businesses in a mature phase is obsolescence.

Personal Considerations

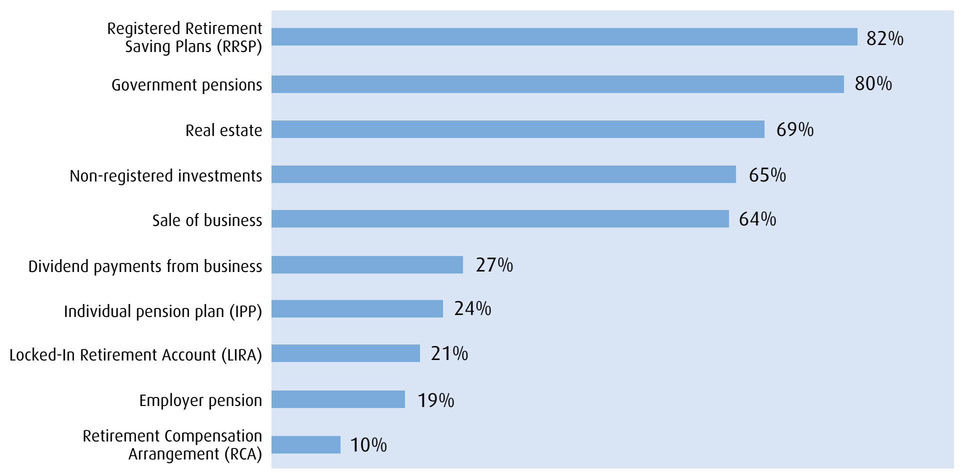
Businesses at a mature phase often correspond to business owners who are nearing retirement in their personal life cycle. Business owners at this stage often try to maximize the amount of income that can be withdrawn from their businesses. They may feel that heavy investments in equipment or facilities will not benefit them personally, given a planned retirement that may not be many years away.

As mentioned earlier, many business owners have both business plans and personal financial plans. Not surprisingly, many of those plans (64%) include the sale of the business as a key source of funds for the business owner's retirement. An additional key source of retirement funding are the Registered Retirement Savings Plans (82%) that business owners have contributed to during their working years. A full list of planned sources of income to fund business owners' retirement is shown below.

64%

of business owners expect the sale of their business as a key source of funds for retirement.

Sources of income for business owners in retirement



Source: BMO Wealth Institute survey by Research Now, September 2013.

At this stage, saving for retirement is a priority, especially if business owners have concentrated on their business and not funded their retirement on a regular basis. Estate planning should also be considered, especially the need to have a valid will, and, in provinces that permit it, a secondary will for business assets to minimize future probate costs. At the time that the business owner's wills are being updated, powers of attorney should also be refreshed, providing authority for trusted individuals to take care of the business should the power of attorney need to be used.

Life insurance should also be part of the business owner's estate plan, as it could be used to repay any outstanding corporate debt. Among many other possible uses, insurance could fund buy-sell arrangements with other shareholders, fund income tax liabilities arising upon death, or create an inheritance for children who are not taking over the business.

Life insurance should also be part of the business owner's estate plan.

Succession

Business Considerations

All business owners will eventually exit their business, either in a planned and orderly fashion, or in an unplanned way that potentially reduces the value of the business and has the potential to cause family disharmony. The transfer of the business could be to a family member, a business partner, senior management, or a third party. The business may be closed down and wound up if none of these options is possible.

If the exit of the business owner is planned and the transition to new ownership is planned, then risks can be mitigated and tax savings opportunities explored. When transition planning occurs, it gives an opportunity to determine if any of the children of the business owner have the necessary skills and desire to take over the business. If the succession of the business is to parties outside of the family, consideration will have to be given to selling the shares of the company or the assets of the business. There may be tax-planning opportunities to use the owner's capital gains exemption, and potentially the spouse's or other family members' exemptions as well.

If the exit of the business owner is planned then risks can be mitigated and tax savings opportunities explored.

Personal Considerations

While many business owners in the survey indicated that they have a business plan (79%), a much smaller number indicated that they have a succession plan (only 39%). This lack of succession planning may go part of the way to explaining why the number one thing that keeps business owners up at night is worrying about being able to retire from their business.

Since a clear and well-planned succession plan helps to maximize the value of the business being transferred, succession planning should be undertaken well before the actual planned exit from the business. Unfortunately, many business owners do not even have a plan for who will take over their business; 39% reported that this worry is one of their biggest concerns. Professionals active in business succession suggest that planning should begin as early as ten years before the planned exit in order for the succession

Only 39% of business owners have a succession plan.

to be most beneficial. This will allow time for either children or senior management to grow into their new roles and establish their authority.

If the business succession involves selling the business to non-family members, life insurance can be used to protect the vendor by insuring the life of the purchaser; if the purchaser passes away prematurely, any outstanding loans could be repaid without depending on company resources.

Funding Retirement from the Sale of the Business

There are two main challenges that many private business owners will face if they plan to rely significantly on the sale of their businesses to fund their retirements. The first is that they may not be able to easily find a buyer, and may end up operating their business much longer than they expected.

Two challenges business owners will face if they plan to place significant reliance on the sale of their businesses to fund their retirements:
• Finding a buyer
• Valuating their business

The second challenge is determining the actual value of their business. In many cases, a business may not be worth nearly as much as the business owner believes. This would especially be the case for businesses that were operated as mature businesses for a long period of time without any investment, expansion, or growth. If there has been no investment in the business, the value of the business may have declined. A valuation by a professional business valuator will help business owners to have a clearer understanding of the value of their business.

Taking a more well-rounded approach to retirement planning, and diversifying the potential sources of retirement income, is an approach that can benefit many business owners.

Conclusion

Planning for business owners poses unique problems, based on the combination of the owner's personal and business situations. The owner's family situation will be in its own unique phase of life, which will be progressing along with the business as it moves through the various stages of the business life cycle. Matching up these two cycles highlights the need for financial and wealth support from a team of supportive and highly skilled advisors.

It is important for business owners to define their financial goals for both their business and their family, and work to integrate these priorities as they progress through the different phases of the family and business life cycles.

We believe proactive planning and professional advice go hand in hand. By working with a BMO financial professional who understands the importance of looking at a business owner's business and personal needs at the same time, Canadian business owners can develop a thoughtful plan and enjoy greater peace of mind.

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[1] Canadian Federation of Independent Business (CFIB): Small Business Facts.
[2] Canadian Federation of Independent Business (CFIB): Small Business Profile, October 2009.
[3] BMO Wealth Institute study conducted by Research Now with a random survey sample of 301 Canadian business owners, conducted between August 29 and September 9, 2013.
[4] BMO survey conducted by Pollara between July 22, 2013, and July 25, 2013, with a sample of 602 Canadian post-secondary students. Overall results for a probability sample of this size would be accurate to +/- 4.0%, 19 times out of 20.
[5] BMO Financial Group survey from a Pollara survey with a sample of 1,000 Canadians 18 years of age and over, fielded online between January 17 and 22, 2013. A probability sample of this size would yield results accurate to +/-3.1%, 19 times out of 20.
[6] Canadian Federation of Independent Business (CFIB): Small Business Profile, October 2009.
[7] Matt Lundy, "10 reasons why businesses fail," Canadian Business Magazine, October 18, 2012.
[8] Morgan O'Rourke, "Industries at Risk of Extinction," Risk Management, December 12, 2012.