The financial balancing act for business owners

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

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.

But there are benefits to being your own boss that owners of the 26.8 million small businesses in the United States have chosen to pursue1. 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 may be 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 their trusted professional relationships.

Recently, a survey was conducted by the Deloitte Center for Financial Services. One of the themes explored was the extent to which business owners planned and the sense of financial security that resulted. The survey indicated that overall 87% of business owners feel very secure or somewhat secure about their retirement. This percentage increased to 96% when the business owner also had a financial plan, but dropped to 81% when they

52% of business owners have a financial plan.
did not have a financial plan. Interestingly, only 52% of the business owners surveyed had a financial plan.

The confidence that business owners have in their financial futures also compares favorably to the general population. Asked the same question, only 72% of the population felt secure or somewhat secure about their retirement.

Each business owner faces unique financial issues; however, there are some common threads that intertwine the business and personal concerns of the business owner over the business and personal life cycles.

**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 affect both the business and the owner personally.

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 may 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.
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.

The desire to start a business is on the rise among recent graduates. According to Entrepreneur.com, 71% of Millennials (also known as Generation Y) with “regular” jobs would like to quit in order to work for themselves, with 60% of those wanting to become entrepreneurs within the next two years.

Yet overall US census statistics indicate that only a small percentage of business owners are Millennials. The most recent data available (2007) breaks down business ownership by age as follows: under 25 (2.2%), 25-34 (10.5%), 35-44 (21.2%), 45-54 (29.6%), 55-64 (24.1%) and 65 and over (12.5%). But the trend towards younger business ownership is taking hold. According to a 2012 report by the Kauffman Foundation, the number of entrepreneurs in the 20-34 year age range has more than doubled to 29.4% of the entrepreneur population. It also reports that 160,000 new start-up businesses a month were headed by Millennials in 2011.

There is also a rise in the number of baby boomers operating businesses as a pre-cursor to full-retirement or in fact, an alternative to retiring altogether. Data from the U.S. Small Business Administration shows that the number
of self employed individuals over the age of 50 has increased from 18.2% in 1992 to 24.5% by 2010. This trend indicates both an increasing reliance on self employment for baby boomers as they age, and at the same time a slowing rate of retirement among those that choose to be self employed. The incidence of part-time self employment also rose during the survey period.

The data also indicated that self-employed individuals also plan to work to an older age. The expected retirement age in 2010 for non-self employed workers was 68.4 years, and 72.6 years for self employed individuals.

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 the children’s educational expenses.

**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.
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 their businesses later in their working years, and even in their pre-retirement years.

As a hypothetical example, at the age of 48, Tyler lost his role as head of a development when the technology firm where he was employed was purchased by a larger competitor. After several months of unsuccessfully looking for a similar role 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.

Depending on their level of savings, retirement assets and pensions that have been 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 every day expenses, business owners can consider allocating funds to reduce the personal risks that they face. Health-related risks can be mitigated through the use of a basic health care plan, disability insurance, and life insurance. Insurance can provide the funding necessary to protect the business owner’s family if any of these events were to 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. US Census data indicates that incorporation is a popular option with 38.5% of the businesses set up as S-corporations and 31.1% of businesses set up as C-corporations.
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 further 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, the 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 dependents at home or are still supporting their children as they complete their college education.

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 SEP IRAs, Traditional and Roth IRAs and 401(k) plans provide tax advantages at the time of contributing funds that will be accumulated to meet future needs.

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 Forbes Magazine, many small and medium sized businesses do not survive to the five year mark. In the first year the failure rate is 25% and by the fifth year more than half (55%) of businesses fail.

Business owners must constantly monitor their environment to ensure that threats and opportunities are considered as they regularly review and update their business plans. These threats can include 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 creates a tremendous amount of value for the company and a reward system helps to ensure staff retention and prevents 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 business 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 attract and retain staff. As an employee, the business owner would be able to participate as well. Under the Affordable Care Act, starting in 2015, any business with 50 or more employees is required to provide a health care plan or pay a fine.

As the company has grown in size and value, there may be an opportunity to initiate tax planning measures such as the introduction of corporate structures that can be used to help retain excess profits generated from the business.
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.

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 clear planned payback on the investment in a reasonable period of time.

Maturity

Business Considerations
A mature business has tremendous advantages and tremendous disadvantages. On the plus side, the business is likely to 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 may 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.

**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.

The Deloitte Survey noted that only 10% of business owners expected that the sale of their businesses will fund the majority of their retirement. Yet, 62% of the business owners surveyed expected the sale of their businesses to contribute between 10% and 50% of their retirement savings.

According to a white paper issued by the U.S. Small Business Administration, business owners are investing funds in various retirement plan options. Business owners favor IRA plans (35.6% participation) to 401(k) plans (17.4%). For business owners that also own a home, or own both types of plans the rate of participation jumps to over 60% for each. The relative favor of IRA plans over 401(k) plans also relates to the fact that many small businesses do not provide employer sponsored retirement savings options for their employees and owners.

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. 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 considered as 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 and estate tax liabilities arising upon death, or create an inheritance for children who are not taking over the business.

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 available to reduce both current taxes and estate taxes in the future.

Personal Considerations
While many business owners have a business plan, relatively few have a formal business succession plan (only 25%)\(^\text{10}\). 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. Professionals active in business succession suggest that

Only 25% of business owners have a succession plan.
planning should begin as early as ten years before the planned exit in order for the succession 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.

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 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, American business owners can develop a thoughtful plan and enjoy greater peace of mind.

---

3 SBA Office of Advocacy, Small Business Profile: Advocacy - the voice of small business in government
2 Deloitte, (2013). Business Succession and Retirement Planning: Are you covering the Bases?
3 United States Census Bureau: Statistics for Owners of Respondent Firms by Owner’s Age, by Gender, Ethnicity, Race, and Veteran Status for the US: 2007. Millennials Are Snubbing the Corporate World for Entrepreneurship (Infographic)
4 Gen Y grads more likely to launch start-ups, USA Today
6 U.S. Small Business Administration. (2013). Employers with 50 or More Employees

United States Department of Treasury Regulation Circular 230 requires that we notify you that this information is not intended to be tax or legal advice. This information cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed on the taxpayer. This information is being used to support the promotion or marketing of the planning strategies discussed herein. BMO Financial Group and its affiliates do not provide legal or tax advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

Estate planning requires legal assistance which BMO Financial Group and its affiliates do not provide. BMO and BMO Financial Group are trade names used by Bank of Montreal.