CHAPTER II

THEORETICAL BACKGROUND

II.1 Family Business

A family business is a company owned, controlled, and operated by members of one or several families. A family-owned business is any business in which two or more family members are involved and the majority of ownership or control lies within a family.

Family businesses may include numerous combinations of family members in various business roles, including husbands and wives, parents and children, extended families, and multiple generations playing the roles of stockholders, board members, working partners, advisors, and employees. Family-owned businesses may be the oldest form of business organization, and today they are recognized as important and distinct participants in the world economy.

According to Nancy Bowman-Upton in the Small Business Administration publication *Transferring Management in the Family-Owned Business,* about 90 percent of American businesses is family owned or controlled. Family businesses may have some advantages over other business entities in their focus on the long term, their commitment to quality (which is often associated with the family name), and their care and concern for employees. But family businesses also face a unique set of management challenges stemming from the overlap of family and business issues.

Family participation in a business can strengthen the business because family members are very loyal and dedicated to the family enterprise. However managing a family business, and particularly succession planning, can present some unique problems. Often family interests conflict with business interests, for example hiring a family member who is less competent than a non-family member or keeping an underperforming family member in a position when their performance is hurting the company. Psychologists are often consulted to help families successfully manage issues that affect both the family and the business

II.2. Family Business Succession Planning

According to Mark Dunemann and Rowena Barrett, succession refers to the transfer of the management and/or the control of a business. Succession is determining who will take over leadership and/or ownership of the company when the current generation retires or dies. Ownership succession focuses on who will own the business, when and how will that happen. Management succession focuses on who will run the business, what changes will occur, when will they be accountable for results and how will results be realized.

Succession planning involves deciding who will lead the company in the next generation. Unfortunately, less than one-third of family-owned businesses survive the transition from the first generation of ownership to the second, and only 13 percent of family businesses remain in the family over 60 years. Problems making the transition can occur because the business was no longer viable or because the owner or his or her children did not want it to occur, but usually result from a lack of planning. Business owners may be reluctant to face the issue because they do not want to relinquish control, feel their successor is not ready, have few interests outside the business, or wish to maintain the sense of identity work provides. But it is vital that the succession process be carefully planned before it becomes necessary due to the owner's illness or death.

Business succession planning should be a priority for every family business. Sooner or later, everyone wants to retire. But if you own a family business, retirement isn't just a matter of deciding not to go into the office any more. Besides ensuring that the founder has enough money to retire on, the whole question of what happens to the business becomes paramount. Who's going to manage the business when the founder no longer works the business? How will ownership be transferred? Will the founder's business even carry on or will you sell it?

Sooner or later, the founder's spouse and children are drafted into the business operations because the family standard of living is directly tied to the business or the entrepreneur desperately needs help just to stuff the operations. The family members are extremely valuable assets to entrepreneur because they are often willing to put in long hours at low pay to help the business succeed. A common saying among family business is:” The first generation creates, the second inherits and the third destroys”.(Wheelen and Hunger, 2006). This fact has very close relationship with the greater challenge and also because of the lack of succession planning. For example in the United States, in fact only 28% of family owned businesses prepare the succession plan, the rest is just inherited from the owner.

Business succession planning seeks to manage these issues, setting up a smooth transition between the founders and the future owners of the business. With family businesses, succession planning can be especially complicated because of the relationships and emotions involved - and because most people are not that comfortable discussing topics such as aging, death, and their financial affairs.(Susan Ward)

If there's no carefully drawn and well-managed succession plan, it's likely that the senior generation, the successor generation, the employees and everyone else in the business' universe will be close to clueless about what's coming next.

Unless that condition is corrected, the company usually starts to lose customers and competitive momentum, falls prey to internal conflicts and then noses over in a painful descent into failure. Trying to work through a succession transition without good planning and strong management is like trying to change drivers in a moving automobile. There comes a point in the process where no one is fully in control of the wheel, the accelerator and the brakes, and everybody on board is just trusting to luck.

A low-risk transition between generations of owners and managers is guided by planning, planning and planning. Solid succession planning produces succession goals -- a view of what the business should look like when the transition is completed -- a clear pathway of decisions and actions that must be taken to reach those goals, and a full complement of family, employees and other stakeholders who are informed, prepared and supportive.

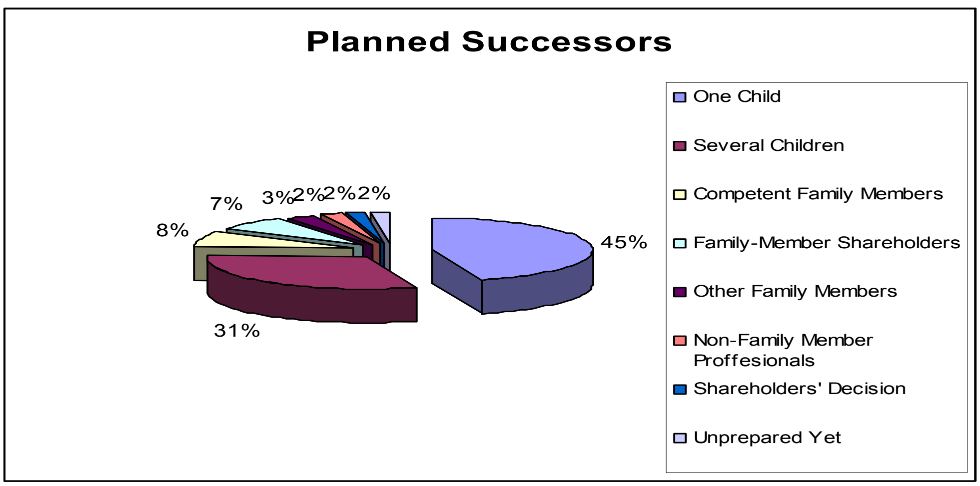
The riskiest transitions for a family business are those produced by a significant growth spurt, a restructuring of the organization, and ownership and management succession. When a flood of new business or the marketplace take off or a new product demands a quick expansion of capacity, a family company has to change in several ways. Employees are hired, physical facilities are added and maybe new production or tracking technology is installed.

More importantly, a business that's been run tightly by its founder or senior owner becomes subject to a lot of new influences. The change-over period can feel like an acrobat leaping between two swinging trapeze bars. One safe hand-hold has been turned loose, the next is still a distance away, and it's a long drop to the dirt. In that space of time, regardless of how brief, the business is at some risk.

Knowing exactly when to begin the succession planning process is perhaps a matter of *instinctive timing*, something that entrepreneurs are good at in other areas of the business. Timing is what usually makes an entrepreneur successful in the first place… knowing when to enter the market, when to build capacity, when to borrow, etc. Knowing when to seriously pursue development of a succession strategy is something entrepreneurs will *intuitively know and feel* at some point in the company's growth.

From the survey that have been done by the Jakarta Consulting Group, in fact not more than two third of the family business in Indonesia do not prepare their successors. For they who have planned, priority of the successors goes to the founder children, the detail can be seen on the chart below

Figure II.1 (Graphic II.1)



Source: Susanto, A.B. *World Class Family Business.* Jakarta: Quantum bisnis & manajemen, 2005.

So who needs succession planning, and when should you get started? The answer, of course, is that every family business can use it and the sooner the better. Companies that wait until a catastrophic event (death of an owner, for example) forces change in leadership will find themselves operating in a troublesome environment, and that's never good for business. In the final analysis, like a lot of other decisions in family owned businesses, starting a succession planning process will probably be an intuitive. And in most cases, that's the way it should be (Don A. Schwerzler, and David A. Jones,)

II.3. Obstacles in the Family Business Succession

According to Wheelen and Hunger in their book Strategic Management and Business Policy, there are some reason family business may fail to successfully transfer ownership to the next generation, which are:

1. Inherited wealth destroys entrepreneurial drive.
2. The entrepreneur doesn't allow for a changing firm.
3. Emphasis on business means the family is neglected.
4. The business financial growth can't keep up with rising family lifestyles.
5. Family members are not prepared to run a business, and
6. The business becomes an arena for family conflicts.

II.4. Strategies of Succession Planning

According to Bowman and Upton in the journal of Transferring Management in the Family-Owned Business, to make succession work, communication is the key ingredient. Use the family retreat as well as family meetings. Family meetings can educate the family in discussions about the nature of the firm, the kinds of leadership skills needed, entry and exit conditions, decision-making policies and conflict resolution procedures. Casual conversations about these issues can contribute to your formal planning later on. Family meetings do not have to be formal affairs, but they should occur regularly and have an agenda. Parents don't have to lead the meeting; have the offspring organize and conduct a portion of the meeting. Use the meetings to defuse any potential time bombs. Anticipate problems. Will there be any problems with non family members? If so, which ones? How will they be a problem, and what can you do (short of firing them) to handle it?

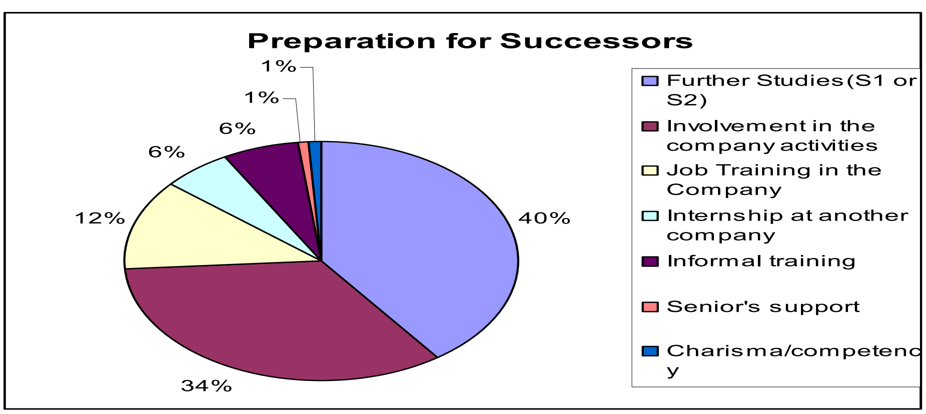
Sibling rivalry is another problem to consider. Does it exist? If so, how will you resolve it? It may not be a problem until the successor is named. Develop a code of conduct for sibling relations. This code will outline how siblings must act toward each other (i.e., in a way conducive to a healthy business), including how to work together, how to play together and how to keep spouses informed about what's going on. Anticipate problems that may arise and meet them head on(Bowman-Upton,1991)

Bowman-Upton recommends that family businesses follow a four-stage process in planning for succession: initiation, selection, education, and transition. In the initiation phase, possible successors are introduced to the business and guided through a variety of work experiences of increasing responsibility. In the selection phase, a successor is chosen and a schedule is developed for the transition. During the education phase, the business owner gradually hands over the reigns to the successor, one task at a time, so that he or she may learn the requirements of the position.

Finally, the transition is made and the business owner removes himself or herself from the daily operations of the firm. This final stage can be the most difficult, as many entrepreneurs experience great difficulty in letting go of the family business. It may help if the business owner establishes outside interests, creates a sound financial base for retirement, and gains confidence in the abilities of the successor.

The chart below shows the preparation that usually done by the family business to support the succession planning. 40% of the respondents give further studies to the successors until S1 or S2, 34% start to involve the successors in the company activities, 12% of the respondents let the successors follow the job training in the company, the other preparation are let the successors follow the internship in another company and informal training (6% each) and the other is the senior's support and because of the charisma or competency.

Figure II.2 (Graphic II.2)



Source: Susanto, A.B. *World Class Family Business.* Jakarta: Quantum bisnis & manajemen, 2005.

Six Business Succession Planning Tips according to Susan Wards

1) Start business succession planning early.

The longer you get to spend on family business succession planning, the smoother the transition process is likely to be.

2) Involve your family in business succession planning discussions.

Making your own succession plan and then announcing it is the surest way to sow family discord. "Opening a dialogue among family members is the best way to begin the process of a successful succession plan — one where close attention is paid to the personal feelings, ambitions and goals of everyone concerned" (Grant Thornton, LLP).

3) Look at your family realistically and plan accordingly.

You may want your first-born son to run the business, but does he have the business skills or even the interest to do it? Perhaps there's another family member who is more capable.

It may even be that there are no family members capable of or interested in continuing the business and that it would be best to sell it. Examine the strengths of all possible successors as objectively as possible and think about what's best for the business.

4) Get over the idea that everyone has to have an equal share.

While this is a nice idea in theory, it may not be in the best interests of your business. Remember that management and ownership are separate business succession planning issues. It may be fairer for the successor(s) you have chosen to run the business to have a larger share of business ownership than family members not active in the business. Or it may be best to transfer both management and ownership to your chosen successor and make other financial arrangements to benefit your other children.

5) Train your successor(s) and work with them.

How can you expect your successor to take over and run your business successfully if you haven't spent any time training him or her? Your family business succession plan will have a much better chance of success if you work with your successor(s) for a year or two before you hand over the reins. For solo entrepreneurs, sharing decision making and teaching business skills to someone else can be difficult, but it's definitely an effort that will pay big dividends for the business.

6) Get outside help with your business succession planning.

Lawyers, accountants, financial advisors - there are many professionals that can help you put together a successful succession plan. There are even companies that specialize in family business succession planning, who will facilitate the process of working through both family and succession plan issues.

If you want to pass your family business along to the next generation, putting off business succession planning is the worst thing you can do. A good succession plan can ensure that you have the funds you need to retire and that the business you have built continues to thrive in the hands of the next generation

Transfer of Power in a Family Business according to Churchill and Hatten :

Table II.1

Phase 1	**Owner- Managed Business:** Phase 1 begin with startup and continue until the entrance of another family member into the business on a full-time basis. Family considerations influence but are not yet a directing part of the firm. At this point the founder and the business are one.
Phase 2	**Training and Development of New Generation:** The children begin to learn the business at the dining room table during early childhood and then through part time and vacation employment.
Phase 3	**Partnership between Generations:** At this point, a son or daughter of the founder has acquired sufficient business and managerial competence so that he or she can be involved in key decisions for at least a part of the company. The founder's offspring, however, has to first gain respect from the firm's employees and other managers and show that he or she can do the job right. Another issue is the lack of willingness of the founder to share authority with the son or daughter. Consequently a common tactic taken by the sons and the daughters in family businesses is to take a

	job in a large, established corporation where they can gain valuable experience and respect for their skills.
Phase 4	**Transfer of Power:** Instead of being forced to sell the company when he or she can no longer manage the business, the founder has the option in a family business of turning it over to the next generation as part of their heritance. Unfortunately, some of the founders cannot resist meddling in operating affairs and unintentionally undermine the leadership position of the son or daughter. To avoid this problem, the founder should sell his or her stock and physically leave the company and allow the next generation the freedom it needs to adapt to changing conditions.

Source: N. C Churchill and K. J Hatten, "Non-Market- Based Transfer of Wealth and Power: A research Framework for Family Businesses", American Journal of Small Business (Winter 1987), pp. 55-64.

James Lea, recommended five ways in which current leaders of family-owned enterprises can attract future generations to keep the business afloat after their retirement or death.

- Expose family members to all aspects of the business, including employees, customers, products, and services.

- Define the business's attractive qualities in terms that will appeal to the listener.
- Recognize those factors that have the potential to discourage family members from staying involved in the business. These factors can range from personal interests that lie in other areas to conflicts with other family members.
- Reward family members who decide to join or stay with the family business. "The 'price' successors pay to join and operate your business may include giving up career options that are financially and personally attractive," noted Nelton. "It may mean loss of privacy, or the tension that occurs between parent and child when their management styles conflict. Lea says a business may make compromises—such as making it possible for the successor to spend more time with his or her family or hiring an interim senior manager to buffer conflicts between parent and child. But the company's 'cost' and the successor's 'price' must be affordable to both."
- Give family members outlets to explore their ideas, interests, and concerns.

It is important to also keep in mind the following principles of succession planning:

Table II.2

PRINCIPLED FAMILY SUCCESSION PLANNING
✓ A business' economic value increases when solid organizational succession planning is in place; ✓ The most essential ingredient for the successor is one of an attitude of stewardship ✓ Protection of the current owner's personal financial security is a key to a complete succession plan ✓ Usually owners require a number of years to adjust to a pending retirement: preparation time to slowly let go of the business and to fully develop outside interests ✓ Gracefully letting go is the final and true test of an owner's leadership ✓ The best gift retiring parents or relatives can give to the business' next generation is trust and independence ✓ It is important offspring or relatives perceive succession as a voluntary, not an obligatory, role ✓ It is sometimes best for successors to avoid working directly for the present owners of the family business for a period of time

✓ Children and spouses, more so than owners, perceive the stress of succession as more emotionally painful ✓ As soon as possible, potential successors should be given specific responsibilities and areas of accountability to which clear cost or profitability results are assigned ✓ Successors need to mix with their peers; talking to other successors helps them realize others share their situation and feelings ✓ The former owner eventually assumes the chairperson's role; responsible for specific policy issues. If authority is unclear, the successor makes the decision ✓ In the end, founders best act as consultants to successors; providing advice and counsel only when asked. Another solid contribution is as cultural ombudsman whose responsibilities are defined by the board of directors ✓ Stock ownership, unless for a very large business or one with shareholder liquidity, is best kept with those family members currently leading the enterprise ✓ Before succession is truly a completed process, funded buy-sell agreements between the new owners should be documented. Also clearly spelled out should be career development paths for other family members and key executives

Table II.2

Source: www.GrantThornton.ca/mgt_papers/