PIFF Newsletter

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PIFF | Purdue Initiative for Family Firms

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Welcome to PIFF!

The Purdue Initiative for Family Firms (PIFF) is an initiative in Purdue's College of Agriculture. PIFF is an integrated research, outreach, and teaching program. It offers educational programs that address the major competencies needed for effective family business ownership and management. The goal of the initiative is to prepare family business stakeholders—strategically, financially, and emotionally—for the significant and sometimes unpredictable transitions and decisions that must be made, which determine the success and continuity of the family business.

PIFF provides multi-generational family businesses with research-based business management resources aimed at improving personal leadership performance and driving operational growth. Our ambition is to prepare family business owners, managers, and stakeholders (including non-owner spouses and future owners) to be effective stewards of their family enterprises.

PIFF publishes a quarterly newsletter that will house an article from each part of the pie, found on our website – purdue.ag/piff. The four quarters of the pie include topics of: estate and personal financial planning, strategic business planning, maintaining family bonds, and leadership and succession planning. Each section houses articles, guides, and assessments of related topics which can be viewed online or downloaded. Also found on the website is a *Question of the Month*, PIFF Research, an option to subscribe to our quarterly newsletter, and upcoming events.

What is Sweat Equity? *Michael Langemeier*

Estate & Personal Financial Planning

"Sweat equity" is a term that describes the contributions of an off-farm heir to the value of the family business. Sweat equity arises in part when an on-site heir receives compensation less than their true opportunity cost to work for the family business. The term also arises in situations where the business has grown substantially in value due to the managerial ability and efforts of the on-site heir.

As noted above, sweat equity may arise when an on-site heir receives less pay than their true opportunity cost to work for the business and/or the business has grown substantially due to the abilities and efforts of the on-site heir. Let us examine these two items individually. Suppose a returning family member has the opportunity to work for a local retailer that with benefits would pay them $75,000 per year. The family business is currently not able to match this offer but is willing to pay the returning family member a salary and benefit package of $50,000 per year. Benefits may include insurance, housing, and vehicle use. In this instance, sweat equity is the difference between the local retailer and family business opportunities.

Sweat equity also occurs when the business has grown substantially, at least partially because of the abilities and efforts of the returning family member working in the family business. To motivate our discussion, let us assume that the family farm purchased and rented additional land when the family member returned to the farm. The returns to land include operating income and appreciation. To capture appreciation, the land must be sold, which is obviously not often feasible or prudent. Sweat equity can be used to capture land value appreciation that occurs when land is purchased to accommodate the returning family member. If the older generations helped purchase the land, not all of the land value appreciation would accrue to the returning family member.

The above discussion assumed that the family business was profitable and could afford to add one or more returning family members. What if the business is in general not profitable and the family business' equity decreases instead of increasing with the addition of the family member? In this case, sweat equity may be zero. This is why it is sometimes argued that if a family business cannot afford to fully compensate an individual returning to the business (i.e., pay the family member his or her full opportunity cost), the business should not encourage the family member to return.

To measure sweat equity, we need information pertaining to compensation of returning family members, the increase in equity that has occurred since the family members returned to the business, and the percentage of the increase in equity that pertains directly to the returning family member(s). Obviously, this information is not just sitting on the shelf. For an example of how to measure sweat equity, see here.

Improving Small Family Business Success

Family businesses often function without a net. They work by default, as processes and procedures handed down through generations are implemented without consideration of their long-term efficacy. As a result, when difficulties strike many family businesses are unprepared to activate contingency plans.

Agricultural Economics Professor Maria Marshall leads the Purdue Initiative for Family Firms (PIFF), which helps family businesses by approaching their practices holistically. PIFF offers these businesses research-based business management resources that improve leadership and drive growth. The initiative's goal is to help build stewardship among all business stakeholders. Read More.

PURDUE AGRICULTURE Purdue Initiative for Family Firms

Quality Management and Business Planning

Maria I. Marshall

Strategic Business Planning

There has been a repeated call for small businesses to integrate quality management into business planning. The current conceptual definition of quality management is the general set of activities that contribute to the intentional improvement of products and services. Researchers who study the quality management practices of small businesses indicate that the challenges faced by small businesses (identified as relative lack of human, financial, and technical resources) are intrinsically different from those faced by large businesses; thus, they argue that small businesses require a different set of measures for quality. These studies often call for a measure of direct interaction with the customer as part of the quality management function. In fact, some quality management researchers hold that customer satisfaction may be the most important fundamental principle of quality management. As the number and diversity of customer attributes has increased, a conscious awareness of customer needs has become increasingly important to small family firms, especially those seeking value-added opportunities in niche markets that rely on value creation and not commodity orientation.

Two aspects of firm orientation, an outward focus on customers and a more inward focus on operations, are both critical to effectiveness of quality processes, and thus, of effective business planning. One of the points of agreement across quality management authors is that the customer defines quality and that quality creates customer satisfaction that, in turn, leads to an improved competitive position. In fact, customer satisfaction is the cornerstone of quality management and is the motivational force behind Deming's 14-point approach to quality management.

Another central focus of quality management processes is the development and empowerment of employees, not through directives but through the removal of barriers. Employees are key to creating the quality of product or service that meets the expectations of the customer. The focus on product and service quality required to meet customer satisfaction expectations requires employees who are engaged in business success, not employees just being managed by directives. In investigating firm characteristics that impact the relationship between quality management and firm performance, researchers found that smaller firms do better than larger firms, that less capital-intensive firms do better than more capital-intensive firms, and more focused firms do better than more diversified firms. This bodes well for family businesses, which tend to focus on customer satisfaction and rely heavily on their reputation to gain a competitive advantage. In fact, family business experts state that the core values of a family business (e.g. caring and commitment to community) are a key component of its competitive advantage because these core values lend themselves to caring about ones customers.

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Choosing a Successor

Renee Wiatt

Leadership & Succession Planning

There is a large gap between a business owner's desire for their business to continue and actually taking concrete steps to establish a plan for continuity (De Massis et al., 2008; Venter et al., 2005). The 2012 Family Business Succession Survey indicated that more than 55% of family businesses plan to eventually transfer the business to a son, daughter, or other family member. However, 44% of family businesses had not yet started a management transfer plan and 54% had not yet started an ownership transfer plan. Moreover, less than 20% of family businesses had a written management or ownership transfer plan in place. Without plans, disruptions such as sickness of an owner, death of a family business member, a large loss of sales, or loss of key employees can cause businesses to crumble. Choosing a successor is a pivotal step in the succession planning process. When a business chooses a successor, they are concretely saying that they want the business to continue into the next generation.

We used data from the 2012 Family Business Succession Survey to determine what factors lead a family business to choose a successor. Of the 613 family businesses in the analysis, 441 (71.9%) did not have an identified successor and 172 (28.1%) had an identified successor. We found that family-related matters play heavily into choosing a successor. If the business owner intended to sell or give the business to family heirs or successors, then that business was 23% more likely to have identified a successor. Having sufficient capital to transfer the business and the discussion of goals also play very large roles in choosing a successor. If the family met with a professional such as an accountant, business consultant, financial planner, or a lawyer to discuss an estate plan, then their likelihood of having a successor increased by 14%. If family business members met at least quarterly to discuss goals, then they had a 9% higher chance of having named a successor versus those businesses who met yearly or less to discuss goals. For each generation added to the day-to-day management of the business, there was a 7% greater chance that they had identified a successor. The senior generations' wishes had a positive influence on naming a successor as well. Businesses had an 11% greater chance of having an identified successor if the senior generation was prepared to give up control of the family business by delegating management to heirs or successors.

Family business continuity is a primary objective for many. The odds of reaching that goal can be enhanced by families working closely together and by elevating the goal of continuity within the family. Ultimately, developing a continuity plan and implementing that plan is critical.

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New Resources on PIFF's Website

Should Sweat Equity be Used to Compensate a Returning Family Member? *Michael Langemeier*

How Should Business Income be Divided? *Michael Langemeier*

Transferring Farm Machinery through a Lease Agreement *Michael Langemeier*

Transferring Business Management *Michael Langemeier*

Is Working with Your Spouse Good for Business? The Effect of Working with Your Spouse on Profit for Rural Businesses *Tia Michelle McDonald, Maria I. Marshall, Michael S. Delgado*

Introducing a New Functioning Assessment for Family Businesses: THE FB-BRAG *Renee Wiatt and Maria I. Marshall*

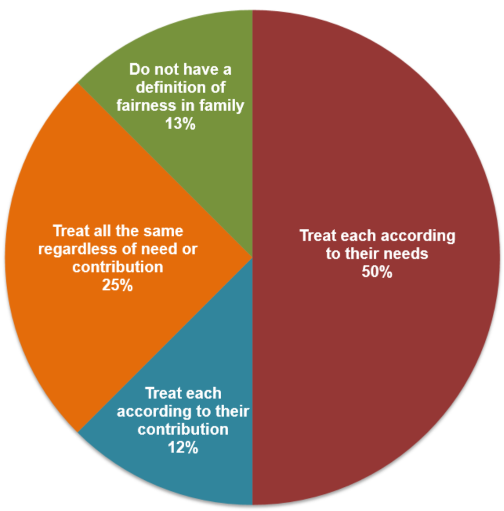
Fairness in the Family Business

Renee Wiatt

Maintaining Family Bonds

Fairness should be important in any business, but how can a family's definition of fairness affect profit, income, and tension in the business? February's question of the month asked "Which of the following best describes how you define fairness in your family?". We asked the same question in the 2012 Family Business Succession Survey (FBSS). By examining incomes, profits, and tension levels by how families define fairness, we can infer how definitions of fairness impact family businesses.

Families and family businesses can define fairness in one of four ways: 1) treating each member according to their needs, 2) treating all members the same regardless of their contribution, 3) treating each member according to their contribution, or 4) no definition of fairness in the family. According to the Question of the Month, half of family businesses defined fairness by treating each family member according to their needs. However, this definition of fairness led to the lowest average business income and profit according to the FBSS. The highest levels of tension were found in businesses that define fairness by treating everyone the same regardless of their need or contribution.



"Treating each member according to their contribution" is a definition of fairness that can be backed up by facts, not just feelings. Hence, it should not come as a surprise that family businesses that define fairness in this way receive the highest business income and profits of all other definitions. High profits cannot mitigate the fact that this definition of fairness leads to the highest levels of tension in the family business. These high levels of tension could come from resentment that everyone is not treated equally, or "the same regardless of need or contribution".

"Treating each according to their needs" was the definition of fairness that proved most problematic for family businesses. Although tensions under this definition were fairly low, so were business incomes and profits. Treating each member of the family business could cause a drain on the family business, leading to the low incomes and profits. We can infer from the previous findings that tension is not always detrimental to family businesses and that having a measurable definition of fairness in a family business can lead to higher incomes and profits.

Which of the following best describes how you define fairness in your family?

	Average Business Income	Average Business Profit	Tension Index
Treat each according to their needs	**$ 257,194**	**$ 49,640**	9.3
Treat all the same regardless of need or contribution	$ 296,216	$ 80,734	**9.0**
Do not have a definition of fairness in family	$ 331,051	$ 54,936	9.6
Treat each according to their contribution	**$ 452,183**	**$ 113,889**	**11.0**

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