SUCCESSION AND TAX STRATEGY FOR FAMILY COMPANIES

Linking the behaviors of family leaders and teams directly to profitability and valuation outcomes

A Behavioral Finance Approach

PERTH LEADERSHIP INSTITUTE

White Paper

A Behavioral Finance Approach to Succession and Tax Strategy for Family Companies

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Executive Summary

Two of the most important issues in family companies are succession and tax. Often these can be in conflict. But they are complex areas that need to be approached objectively and carefully.

In both areas there are conventional tools and metrics that provide a high level of useful data and approaches. But they don't usually formally link behaviors of family units and leaders to longer-term valuation, financial and business outcomes.

The Perth approach provides a unique framework for identifying the behavioral correlates of successful business and financial outcomes. These are based on several proprietary and unique psychometric assessments that link leadership and family unit behaviors to objective measures of company and business outcomes.

This results in the creation of detailed behavioral forensics that can be used to drill down in these areas to the precise behaviors linked with different valuation and business outcomes.

These tests are fast to complete, very accurate and highly insightful. They can provide a new foundation for family company leadership, management and company sustainability.

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Behavioral Finance and Business Acumen

Perth Leadership Institute formally defines business acumen as "the behavioral propensity to create capital". This definition is based on psychometric research based on behavioral finance by Dr. E. Ted Prince. Our informal definition is "the ability to create positive financial outcomes". It is also defined colloquially as “a nose for profit."

Ram Charan defines business acumen as “linking an insightful assessment of the external business landscape with the keen awareness of how money can be made — and then executing the strategy to deliver the desired results.” (Strategy and Business, February 28, 2006)

The leadership development community has been relatively late in linking business acumen to behavioral finance. It has become clear that business acumen is about behaviors rather than about knowledge or qualifications. The emergence of behavioral economics and finance shows us that business acumen is a result of unconscious cognitive biases that collectively enable a person to have a sustainable ability to create wealth.

Behavioral Finance and Prediction of Company Valuation

We now understand that if you can identify financial behaviors in a quantitative way that links these behaviors with outcomes, you now have a revolutionary new way of approaching investment performance. In fact, you can use management behaviors as a way of predicting future valuation. this overcomes the deep problem that financial metrics are lagging indicators of performance. Behaviors are leading indicators of performance.

This means that financial behaviors can be used as a new approach to areas such as credit ratings, stock ratings, asset allocation and portfolio management. However, to be able to this this you need scientifically derived metrics on financial behaviors. This is what Perth Leadership Institute has been doing for the past 16 years.

Defining Business Acumen in Quantitative Terms

Perth Leadership Institute has developed assessments which assess and measure the business acumen of individuals and teams. These assessments are based on the Perth Leadership Outcome Model, developed by Dr. E. Ted Prince. The underlying model is based on a behavioral finance paradigm. We have operationalized this definition by defining business acumen as being the difference between the innovativeness of an individual and the resources used in achieving that particular level of innovation.

We can adopt this approach because innovativeness is reflected in the gross margin impact of that person and their resource use is reflected in their expense impact. The difference between gross margin and expenses is operating profit. This reflects the level of business acumen of this individual. Therefore, we can define business acumen in both behavioral and quantitative terms, as reflected in the income statement of an individual or a company.

Our Research into Business Acumen

Our research supports and extends other research in the areas of behavioral economics and behavioral finance. These emerging disciplines have shown that there are underlying cognitive biases that affect business decisions and often lead to poor and unintended financial results.

These decisions need not be financial decisions. The underlying idea behind our research is that all decisions have financial consequences, even if they are not explicitly about financial matters. If we wish to understand the financial performance that results from our leadership, we must understand and measure these cognitive biases in order to be able to predict financial outcomes and performance and in order to be able to improve them.

Everyone has cognitive biases. Most of these biases tend to adversely impact financial outcomes. Our cognitive biases are different in their strength and impact. We each have financial traits and these cognitive biases mean that these financial traits result in different financial performance depending on who is managing and leading.

Because each individual has unique personal financial traits, there are innate calculi that manifest in our financial decisions; financial signatures that are innate and which cannot be changed. The expression of these financial traits is an individual's financial mission, which, through the growth of an individual's business acumen and through self-awareness from training, can be altered. Though unconscious, these behaviors can be targeted and controlled in order to improve financial outcomes including profitability and valuation through the development of business acumen.

Business Acumen Assessment Instruments

Perth's behavioral assessments can predict the financial outcomes from a person's or a team's behaviors based on their measurements of the cognitive biases that impact financial outcomes. With these results, business acumen development programs can intervene and improve the financial decision-making capabilities of an individual or team based on improved self-awareness of the behaviors that lead to positive financial outcomes.

Improved business acumen sharpens a person's or a team's ability to link one's own behavior to the external business playing field with a new awareness as to the behavioral linkages involved. Perth's business acumen programs, business acumen seminars, and business acumen assessments are designed to provide awareness and development of business acumen at the individual, team, and company level.

Business Acumen and Financial Education

It is important to note that business acumen is not the same thing as financial education or literacy. The latter is formal knowledge that can be learned. However, learning may not affect decision-making favorably. Often higher financial literacy may lead to poorer decision-making due to the increased strength of the cognitive bias of over-confidence.

In short, the key issue in achieving positive financial outcomes is not financial knowledge per se but an awareness of the links between behavior and financial outcomes and the mental agility needed to change one's behavior, even when this is not comfortable for the decision-maker.

For more of Perth Leadership's insights on business acumen, you may be interested in our White Papers, The Role of Business Acumen in Leadership Development and Succession Planning and Business Acumen.

See Prince, E. Ted, The Three Financial Styles of Very Successful Leaders: Strategic Approaches to Identifying the Growth Drivers of Every Company, McGraw Hill, 2005.

See also E. Ted Prince's seminal article on business acumen in CEOs "The Fiscal Behavior of CEOs", MIT Sloan Management Review, Fall 2005, pp. 23-26.

Prince, E. Ted, "Business Personality and Leadership Success: How to Use the Leadership Cockpit to Improve Your Career and Company Outcome", Amazon Kindle, 2011

The Perth Leadership Outcome Model

Traditional leadership approaches are based on the idea that leadership comprises a series of characteristics that endow the leader with the ability to get followers. That approach is fundamentally a psychotherapeutic model.

Perth has developed a totally different type of model. That model is based on the principle that, from the business leader viewpoint, business outcomes are heavily determined by the cognitive biases of the business leader. In the Perth model a leader is not successful necessarily because of her ability to get devoted followers. The leader is successful only if they bring about a change in valuation that is more than existed before taking on the job.

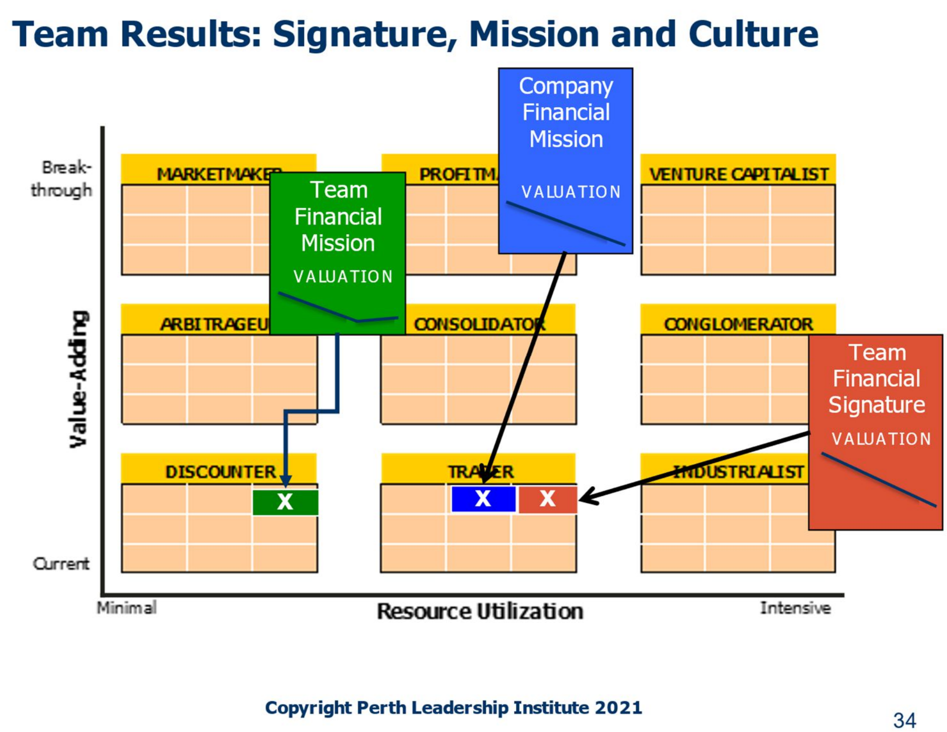
The model that Perth has developed is called the Perth Leadership Outcome Model (PLOM). The model shows what the outcome of a business leader's cognitive biases can be. Essentially the Perth model links cognitive biases with company valuation. By modifying these biases, a higher valuation can be achievable.

The Perth Leadership Institute has developed formal test instruments to identify and measure the type of personal profile of any business leader. The leadership types developed by the Institute are associated with specific types of valuation and business outcomes. These outcomes can be measured using conventional financial metrics. These metrics derive from the financial signature of the leader and their leadership outcome type. The financial signature is a concept developed by the Perth Leadership Institute. It allows us to provide a formal basis for linking financial signature and leadership outcome type with the corporate valuation outcome.

High-Level View of the Model

We can plot all these outcomes on the same diagram. This has the benefit that it shows the valuation outcome for each leadership outcome construct. We can do this at the level of the individual or we can do it at the level of the team. The latter is more useful when dealing with a company so that we know the outcome at the aggregate level. As can be seen we want to know what the valuation outcomes are based on the team financial signature, the team financial mission, and the financial mission at the level of the company. This shows us how these various units are aligned and whether or not the level of alignment is enough to be productive or unproductive at the level of the company.

FIGURE 1 HIGH-LEVEL VIEW OF PLOM



The Perth Assessments

Financial Outcome Assessment (FOA)

This provides feedback about your behavioral capacity to create capital. It uses two dimensions. The first is your capacity to add value both in a financial and more general sense, The second is your propensity to use resources in order to achieve that particular level of value.

As you can see this spans a range of possibilities including achieving high value at a low level of resource utilization and achieving a low level of value at a high level of resource utilization. Everyone falls within this range, and you can see your own particular level in this report.

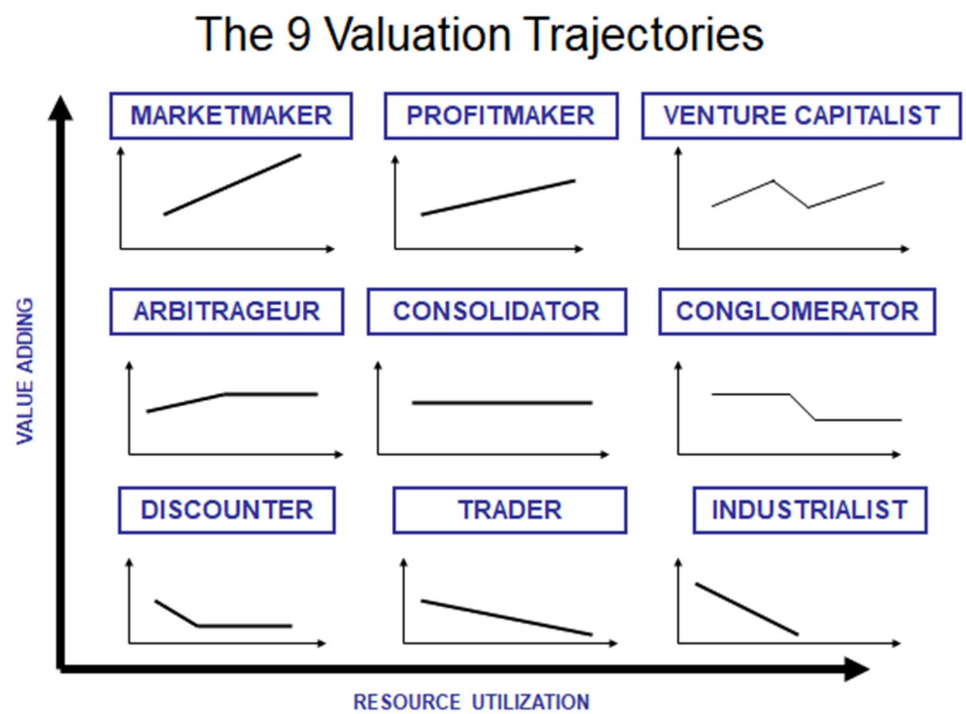
We call this particular level your "financial signature" ™. There are nine financial signatures and yours will be in one of the three categories namely, value-centric, resource centric, or balanced, basically break even. Your financial signature™ is innate and does not change but your financial mission, which is how you express this propensity in practice, can be changed.

The financial signature is also a measure of behavioral risk. In particular it shows the risk of over-spending or under-spending. It also shows the risk of not being able to meet levels of value that will result in satisfactory earnings.

FIGURE 2 FINANCIAL OUTCOME ASSESSMENT

AS WE CAN SEE, EACH FINANCIAL SIGNATURE HAS A CORRESPONDING VALUATION OUTCOME OVER THE LONGER-TERM. WE SHOW THESE BELOW. ACTUALLY, OUR ASSESSMENTS BREAK THESE DOWN INTO 81 VALUATION TRAJECTORIES – 9 FOR EACH DISCRETE FINANCIAL SIGNATURE. SO, BY USING VALUATION OUTCOME WE CAN ALWAYS SEE THE OUTCOME OF ANY BEHAVIOR, BE IT THE FINANCIAL SIGNATURE, THE FINANCIAL MISSION OR THE LEADERSHIP OUTCOME TYPE.

FIGURE 3 VALUATION TRAJECTORY OUTCOMES



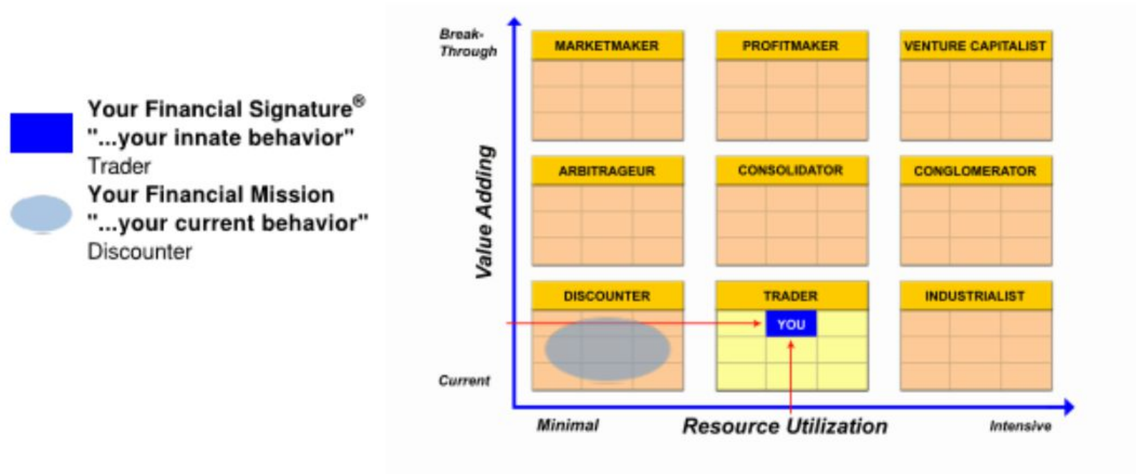
Financial Mission Outcome Assessment (FMOA)

Your financial mission is how you express your financial signature™ in practice. This might be different to your financial signature™ for many reasons. Your financial signature™ is innate but often your financial mission will be different for a variety of reasons.

In the Financial Summary report, we show your financial mission and compare it to your financial signature™ to see if they are the same or are different. If they are different, we want to know why, and what this means for both your individual and team performance.

The aim is for your financial mission to be as close as possible to the financial mission of your organization providing that that particular financial mission is appropriate for it. If the financial mission of your organization is not close to the optimal organization mission, the aim is for your own mission to be as close as possible to the optimum financial mission of the organization or for your own optimal personal financial mission.

FIGURE 4 FINANCIAL MISSION OUTCOME ASSESSMENT

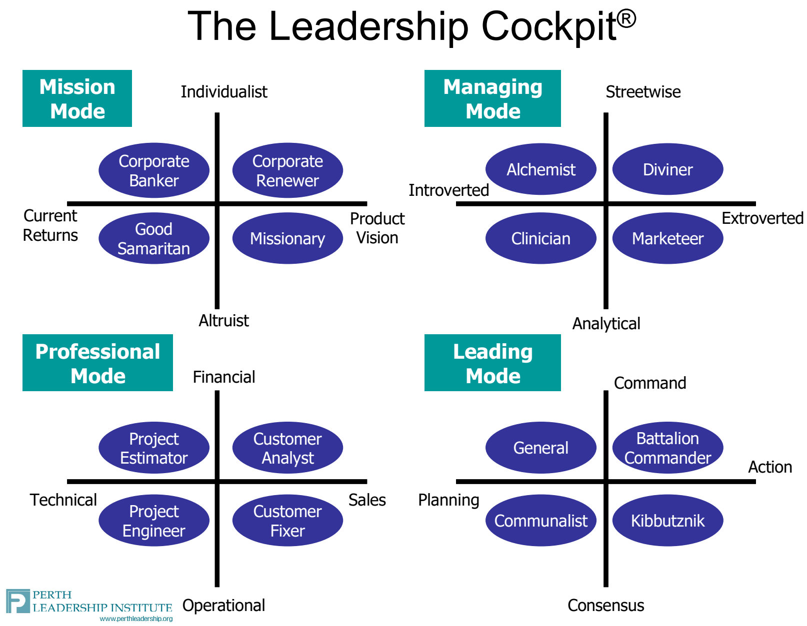


Executive Outcome Assessment (EXOA)

The EXOA shows your business impact on the organization, namely how your behavior and decisions impact the main business activities in terms of their content and execution. It shows the characteristic ways your decisions will skew to achieve different types of outcomes. It will show you the areas you tend to ignore or not to emphasize enough.

This report is also used to calculate your financial mission. It shows the areas of behavioral risk that will impact both the qualitative functioning of the organization and also the quantitative levels of outcomes you will tend to achieve when compared to your close competitors.

FIGURE 5 EXECUTIVE OUTCOME ASSESSMENT – LEADERSHIP OUTCOME TYPES



Corporate Financial Outcome Assessment (CFOA)

The CFOA reveals the financial mission of the organization as distinct from your personal financial mission. It does this in a way that can be directly compared to your own financial mission. This allows us to evaluate whether your own personal financial mission is aligned or otherwise with the financial mission of the organization. This gives us a measure of fit between you and the organization.

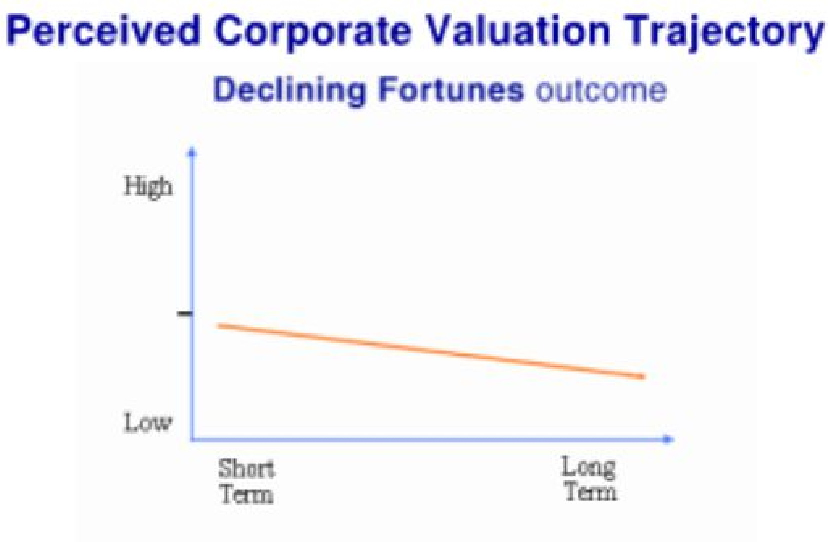
This level of fit is judged on the level of value you provide versus what the organization itself provides. It also shows the fit between your and the organization in terms of your levels of resource utilization and whether or not they are close to each other or otherwise.

The CFOA shows the level of satisfaction with your organization and how well aligned one is to the other. So, the CFOA is a critical report in showing how happy or otherwise one is with the other.

FIGURE 6 CORPORATE FINANCIAL OUTCOME ASSESSMENT

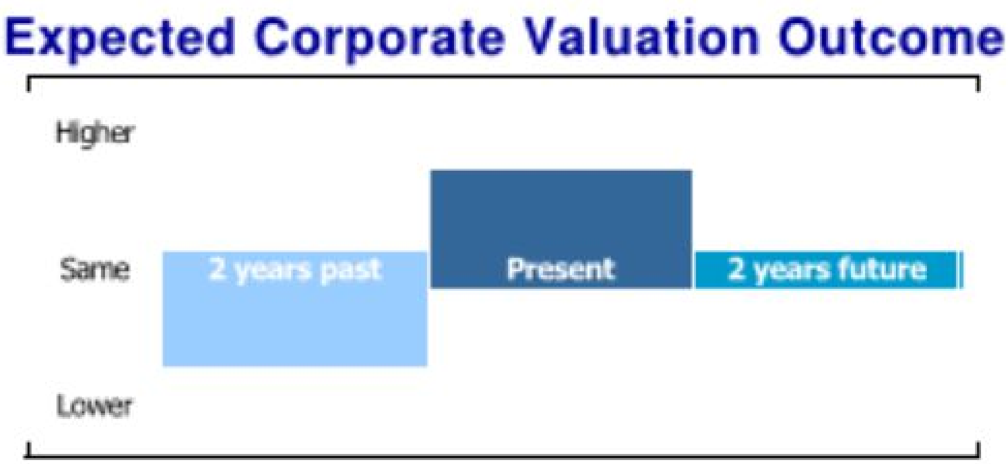
By identifying the financial mission of the company, we can also identify and predict the valuation outcome of the organization. This allows us to compare the financial mission of individuals, and teams and to see the extent or otherwise to which they are aligned with the corporate financial mission. Of course, there could be perfect alignment, but the financial mission of the organization is just inappropriate in which case there is cultural or alignment problem. But this provides a starting point for the discussion comparing individual and team missions and the extent to which they need to be changed to achieve good alignment with the corporate financial mission.

FIGURE 7 PREDICTED CORPORATE VALUATION TRAJECTORY



We can also derive what we call an expected valuation outcome. This is derived from a direct question or respondents in which they know the aim of the question. This is unlike the predicted valuation trajectory where respondents to not know and therefore are not biased in their response. This allows us to compare predicted and expected valuation trajectories so that we can evaluate the extent to which wishful thinking might be biasing the response or the desire to be "with the program".

Figure 8 Expected Corporate Valuation Trajectory



Using the Model for Succession and Tax Strategy

Succession Strategy

In succession strategy we are concerned with maximizing the impact of the leadership on the overall ambit of the company. This means its business, its impact on the community, its valuation, and the cultural impact, specifically the extent to which the family company acts as a family and its level of cohesion going forward. In succession strategy the concern is much more with the longer-term as distinct from the shorter-term. We can get detailed behavioral data from the Perth assessments as we show below:

- Business impact – the leadership cockpit, the 16 leadership outcome types, the type of pf impact, and the psychic intensity of the leadership.
- Social impact – the leadership cockpit and some of the leadership outcome types the degree of engagement with others of the leadership, their level of desire for connectedness, their degree of altruism or otherwise.
- Valuation – the FOA and the 9 financial signatures, the financial missions and the CFOA, that is the corporate financial mission, the financial signatures and missions of leadership and leadership candidates, the extent to which they are value- or resource-centric, their level of value-adding and their level of impact on capital creation.
- Cultural – particular leadership outcome types, their extent of influence on both insider and outsiders, their type of strength of their vision, not just in business, but professionally, socially and ethically and spiritually.

Tax Strategy

In tax strategy we ae much mor concerned with a more narrowly defined idea of business. This is less concerned with business and more concerned with financial impact and cash flow. It is much more concerned with the financial impact on compensation especially for more senior leaders. It is generally much more concerned with the shorter-term than the longer-term.

- Financial impact – the Financial Outcome Assessment, cash generation resulting from leaders' financial missions and the corporate financial mission.
- Cash impact – evaluation objectives and the cash implications resulting from this; especially cash needs resulting from deeply-held preferences and possible philanthropic objectives and cash needs therefrom.
- Regulatory impact and compliance – this may be from broader social and political factors, especially but not only at the local and regional level.
- Legal impact – this includes the legal aspects of tax strategies in their impact on other family members, the longer-term wealth-generation concerns of these members as identified from their financial signatures and missions and their leadership outcome types.

Succession versus Tax Strategy

- Succession and tax strategies can often be potentially in conflict. This is because, in general:
- Succession strategy is longer-term, tax strategy is shorter-term

- Succession strategy usually has business objectives first; tax strategy has financial objectives
- Succession strategy is more about long-term valuation; tax strategy is about shorter-term financial maximization
- Succession strategy is more about culture and cohesion; tax strategy is more about asset leverage.

But the Perth assessments give us a way to deal with these potential tradeoffs. We can do the following:

1. We can compare the behaviors of the various leaders to measure objectively how far apart or otherwise on the different succession and tax metrics
2. We can compare individual leaders to the overall family to see to what extent they are apart or otherwise
3. We can take into account other metrics, for example shared behavioral preferences about the longer-term compare with short-term financial preferences
4. We can have discussions where the precise metrics are not even mapped out in order to explore the major points of difference to make family leaders aware of differences, they weren't even aware of.

In other words, the psychometric assessments give us access to behavioral data and preferences that most family members weren't even aware of so that they can start thinking of their own special ways to resolve differences and get to a more consensual position that harmonizes preferences in both the succession and tax areas.

Getting the Data from the Perth Assessments

Perth provides:

- Data on financial behavior forensics
- Likelihood of creating capital versus consuming it
- Multiple metrics on financial and business behavioral preferences

In particular, it provides detailed behavioral data on the following biases:

- Evaluation of value versus cost trade-offs
- Short- versus long-term preferences
- Altruism versus individualism forensics
- Cash versus assets preferences
- Customer versus products preferences
- Financial versus operations preferences
- Planning versus action preferences
- Command versus delegation preference

In addition, we provide data on shifts for individuals from one bias to another during recent years.

This all provides guidance for choices that make up overall tax strategy.

The data is provided for the following:

- Individual family members
- The family as a whole
- Teams within the family
- Business units comprising the family business
- Behavioral metrics by generation, including the founder and first generation
- Also, the second and third generations
- Comparisons between individuals, teams, business units and between each.

Benefits for Succession Strategy

- Provides a systematic approach to identifying objective behavioral data for succession and talent management purposes
- Identifies factors not normally taken explicitly into account
- Takes a long-term view to valuation and family company sustainability
- Links behaviors directly to profitability and valuation outcomes
- Provides information to allow tradeoffs between financial, business and cultural issues to be surfaced and evaluated
- Provides a level of self-awareness to family members that often does not occur
- Capable of identifying business, financial and behavioral differences between different family units and different generations of family members and leaders.

Benefits for Tax Strategy

- Explicitly identifies and measures behavioral factors critical to tradeoffs in tax strategy
- Shows tradeoffs between financial, business and cultural factors in developing tax strategy
- Provides a behavioral foundation for comparing different leaders and their different valuation outcomes
- Provides self-awareness to family members and leaders that would otherwise often not occur.

Conclusions

The Perth approach to succession and tax strategies provides a new and innovative approach. It does so via the following:

1. Introducing a new foundation for leadership and business strategy based on the disciplines of behavioral economics and finance
2. Providing behavioral metrics for business, financial, cultural and valuation impact
3. Allowing comparison of business outcomes for different leaders and leadership strategies
4. Providing self-awareness and behavioral feedback to family leaders and members