



Enterprising Rural Families™

An Online Newsletter April, 2005 Volume 1, Issue 4

Chat This Month

Reminder: The chat this month is scheduled for North America: Pacific Time- 6 p.m., Mountain Time- 7 p.m.; Queensland, Australia: Eastern Time-12 Noon. The topic is “*Compensation in the Family Business.*”

Suggested Progress by

Group: In order to stay current, by the end of this month you should be completed to:

Antarctic – End of Module 5

Arctic – Second Week of Module 4

Atlantic – End of Module 2

Baltic – End of Module 1

Bering –

Black –

Caribbean -

Coral –

Indian –

Mediterranean -

Pacific -

Red -

COMPENSATING FAMILY MEMBERS: What is fair?

The concept of fairness is vital to the overall satisfaction of family members in a family business. Many of the complexity faced by family businesses are embedded in a lack of justice in the decision-making process governing the family. The principles guiding a non-family business are formal, impersonal contractual arrangements with a compensation philosophy that is explicitly expressed. The familial relationships of a family-run business, characterized by social norms and close ties that define membership within the family, support implicit and informal compensation arrangements that do little to create a harmonious family environment.

It would seem obvious and fairly simple to pay family workers what their job is worth. However, few family business owners pay their family members market value. Compensation is a delicate issue in family businesses. The compensation system for non-family workers is an objective process where by workers are compensated for their job skills and performance of specific tasks. The compensation system of family members tends to be a less objective method of rewarding family members based on their association with the business, which may or may not be tied to longevity or performance. Sometimes compensation of a family member is based on need. Many families' compensation systems have evolved over time or were developed by an earlier generation, but are not suitable now, causing conflict, resentment, and even hostility.

What if fair?

Designing a compensation plan revolves around the issue of what is fair. People differ on what they determine to be fair. Is each family member entitled to an equal share of the family assets? Should the family members who are part of the business receive more than the non-business family members? Should one person receive more because he or she has not done as well as the others? If one child is given a piece of property, how much and what type of compensation should be given to the other children? What seems fair depends on the perceptions of both the person giving the compensation and the person receiving it. How a family business settles on what is fair can often determine how the family functions. There is more than one definition of fair.



Equal - Under this definition, everyone gets the identical treatment based on being a member in the family. This treatment supports the notion that each person is one and the same in the family business. Problems arise when the efforts of the family members who participate in the family business are not recognized.

Equitable - In this case, each person gets what he or she deserves based on merit. This approach supports the business principle that people expect to be paid differently based on the hours worked, responsibilities, experience, abilities, skills, training, and seniority. They also expect to share in the profits and losses proportional to their investments and risks. Problems arise when some family members do not think this approach is fair treatment.

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information: eRuralFamilies.org



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Need - A third definition of fair is based on need in which certain family members receive more than others because they are going through difficult times, have less than other members, can't get their life together, or for other reasons. This type of compensation includes creating a new job position (regardless of whether the job is necessary to the business), raise, promotion, place to live, or a personal loan. Some examples of compensating the "needy" are illegal and include providing "tax-deductible allowance" to college children and "income" and health insurance to needy family members by putting them on a payroll for a phantom job.

This approach, which is in the interest of the individual in need, may benefit the family business if the compensation is legal, does not create dependency or allow problem behavior to continue. It should provide an opportunity for the person in need to contribute as a member of the family and to the family business. Problems with the approach can range from bitterness in the family to financial loss in the business to loss of business integrity.

Business-first or family-first philosophy

How members of a family define fairness reflects the values of the family and the business. What is fair within a family may be different from what is fair within the business. To help determine fairness, the Canadian Farm Business Management Council in *Managing the Multi-Generational Family Farm*, suggests that the first step in developing a fair system is to determine whether the family business operates under a business-first or family-first approach. The approach should be grounded in the culture of the family business. A business-first philosophy compensates family members for their job performance at the market rate for that particular job. Fair is based on the concepts of equity. Under family-first compensation philosophy, fair is based on the concept of equality, where all members are rewarded the same, regardless of individual job performance or on the concept of need, where the individual is rewarded. Either philosophy is acceptable if it makes sense and is understood by the family members.

Confusion about roles



A complication in designing a compensation plan is the role confusion that can occur when making decisions about how to disperse the variety of funds that flow in a family business. It is not uncommon to find payments to family members in their roles as owners, future owners, bosses, employees, care givers, and loved ones confused with compensation for job performance. The array of funds increases the complexity, because of the variety including wages and salaries, merit increases, dividends, bonuses and other incentives, loans, gifts, inheritances, gifts, trusts, perks (free housing, use of vehicle, vacations, personal loans), equity increases in land, and stock-price appreciations.

Are offspring paid more than cousins? If I own 25% of the business, what should I be paid for my daily work? The older brother has been working on the farm full-time in a management position for several years while the younger brother has just returned from the university with a degree in farm/ranch management to work on the farm – how much should the younger brother be paid?

A well-designed compensation plan should present a clear distinction between compensations and gifts. It should provide a rational process for distributing incentives and bonuses. Compensation should be based on payment for business reasons rather than emotional reasons. Questions to ask when determining how to arrive at a fair compensation plan includes:

How are compensations and gifts handled?

Which of the funds are compensations (appropriate for employees including family employees), which are gifts (appropriate for family members), and which funds flow directly to the family business owners?

How are the perks justified? Are they job-related perks?

How are incentives and bonuses distributed?

Are incentives and bonuses based on personal performance or are they based on overall performance to the company?

According to Craig Aronoff, director of the Family Enterprise Center at Kennesaw State College, in Marietta, GA., companies should pay family members what their jobs are worth and keep information open about compensation and gifting to family members, family employees, and business stockholders. When people lack information, particularly about money and asset distribution, differences are overestimated leading to unwarranted speculation, bitterness, and lack of trust.

Designing a compensation plan

It is important that all people affected by a compensation plan (whether they work in the business or not) be involved in the planning process so that they will take ownership in the final decision. The first step in the process of designing a plan is holding regular meetings. Some families have used a family mediator during their family meeting in their desire to ensure familial relations are harmonious. Communication should include the expectations of the individuals in the family with respect to being treated fairly. This process may require discussion about key issues including:

- the culture of the family and business;
- the values of the individuals, family, and business;
- what is fair in different situations;
- how the final compensation plan is in the best interests of the individual, the family, and the business.

If the decision is made to base compensation on market value, the market value for each job needs to be established. Job descriptions for all family members involved with the business work are necessary. Decisions will need to be made about incentives and bonuses. Will they be based on personal performance or overall performance to the company? How will performance be assessed?

Once a compensation plan has been developed, all family members should know the process by which compensation is determined. The philosophy behind the compensation system should be clearly communicated to all those affected to reduce conflict and resentment among family members. The plan should be reasonable, understandable, and applied consistently. It should be a formal, written compensation plan with guidelines for employees, owners, and family members. The plan needs to be reviewed and modified, if necessary, so that it addresses changing business conditions, family life cycle transitions, and other conditions that better reflect current family values and interests and business needs.

One of the most challenging issues for a family business concerns compensation for family members because roles, responsibilities and contributions are rarely equal. The best way to manage family compensation is to establish a compensation plan on sound business standards that are understood by all people affected. Having a well-designed plan will contribute to a harmonious family and business environment.

For more information on this topic and the management of rural family enterprises, check the Enterprising Rural Families website at <http://eRuralFamilies.org>.

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(References on the following page.)



***“After reviewing your job performance son,
we’ve decided to move you into production.”***

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