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The Key Employee Risk

In the world of small business, the success of the enterprise most often is dependent on the services provided by both key owner and key non-owner employees. The loss of a key employee's services due to death, disability or critical illness will, in all likelihood, result in a loss of income to the business. While this income loss may be temporary, there will be increased expenses, some of which will be of a permanent nature.

These increased expenses relate to the following:

- The search firm costs relating to the hiring of a new employee.
- Training costs for the new hire
- Possible "signing" bonus and
- Costs associated with paying an income to the disabled employee or deceased's family.

These types of risks cannot be avoided. They must either be retained by the business or transferred to an insurer.

The first step in determining the risk involved is to determine who the key employees are. These key people can be characterized in one, or more, of the following ways:

- Possesses specialized skills critical to the success of the business
- Has a significant customer or client base
- Is responsible for bringing large amounts of business to the business
- May be a source of capital
- Loss could impair the credit rating of the business
- Loss could result in loss of customer, employee and bank confidence

Identifying these individuals may be more difficult than it first appears. While the owner may be considered a key employee, s/he often overlooks the fact that there are others integral to the success of the business. The owner must be willing to consider the damage that could be caused if any individual were absent for longer than the normal vacation period.

Valuing a Key employee

The valuation of the value of a key employee to a private corporation can be difficult to ascertain. As a generalization the employee's value to the firm is dependent on that unique set of characteristics that s/he brings to the firm. If the employee is an individual who brings substantial amounts of "profitable" business to the firm establishing a value could be relatively easy. We could capitalize, using some factor, the business that this individual brings to the business in excess of the business brought in by a similarly employed but less effective employee. Similarly if the key employee has business goodwill accruing to the business by virtue of his/her presence, and this value can be capitalized then the current value of this key employee can be determined.

Four Traditional Approaches to Key Person Valuation

1. Application of some multiple to the key person's salary

This approach could be used to pay for recruitment and training costs required to hire a replacement for a key person. In certain industries it may also be necessary to pay a signing bonus. These costs alone could represent two to three times the salary costs of the current key person. When we add loss due to reduced earnings, goodwill and employee moral, we could easily have a multiple of up to five times the current employee's salary.

2. The capitalization method

Under this method, we capitalize, at some discount rate, corporate earnings that can be attributed to the key person. As the discount rate and corporate earnings will be subject to fluctuation as the general economy and the business earnings fluctuate, the value determined using this method should be reviewed annually.

3. Reduction in Going concern Value

This method calculates the loss in the going concern value of the business based on the loss of the key person. The loss in value, expressed in percentage terms, is applied to the going concern value.

Example: The business has a going concern value of \$1,000,000. It is estimated that the loss of a key person will reduce this value by 25%. The value of the key person is $\$1,000,000 \times 25\% = \$250,000$

4. Maximum Insurable Value

Under this methodology, the insurance company is left to determine value. It assumes that the maximum amount of coverage an insurer will issue on a key person is that person's worth to the company. This may be a circular discussion, as the insurer will require salary and key skill and attribute information on which to base its decision.

These traditional approaches are simplistic. They assume that the key person's ongoing value to the firm will remain constant, that the replacement costs will not vary, that the business s/he brings to the firm will continue to be profitable, and that additional key people will not be hired. These assumptions are flawed. What is required is an approach that is both conceptually sound and capable of helping business owners make a reasonable determination of key person value.

An approach that includes the following features will produce a more precise value:

- **Forward looking**
 - What will the key person produce in the future?
- **Timing of contribution**
 - Take into consideration the timing of the key person's contribution to the business.
- **Recognition of varying contribution**
 - Take into consideration the fact the key person's contribution to the business is unlikely to remain constant—it may rise or fall over time.
- **Recognize the contribution will end**
 - Take into consideration that the key person's contribution to the firm will stop. The latest this will occur is at retirement. This is inevitable and will happen even if the individual doesn't die, suffer a critical condition, become disabled or resign.
- **Recognize the key person will have to be replaced**
 - Except in very rare cases, if a business loses a key person, that person will have to be replaced. There will, in all likelihood, be substantial costs associated with such a replacement.

What follows is a method of valuing a Key Person's contribution to the business. If this methodology is properly used and explained to the business owners it will provide a statement of the true value of the key person.

This method can be used to draft a set plans to hedge against the loss of the key person should they become disabled, suffer a critical condition, become disabled, die or retire. These plans can ensure that the business can continue as a financially viable entity neither better off nor worse off should the loss be suffered.

Should the business decide to use one or more of the insurance products available in the market to cover the risk, this plan will provide the insurer's underwriters with valuable information to justify the acceptance of such risk.

The steps to be used by the business owner or his/her risk manager are as follows:

1. Determine the planning period

The planning period is the number of years that would be required to hire, train and develop a new employee to the point where s/he would be of the same value to the firm as the individual replaced.

2. Determine net revenue

The net revenue for each year of the planning period will have to be estimated. We will need gross sales and the cost of goods sold to arrive at this number.

3. Determine key person's contribution

The amount of the key person's anticipated contribution to the gross sales revenue of the business, as a percentage, for each year of the planning period will have to be determined.

4. Calculate key employee compensation

The total compensation of the key employee for the duration of the planning period will have to be estimated. This figure must also include the cost of all employer-paid employee benefits.

5. Calculate replacement costs

All of the direct costs for each year of the planning period that relate to locating, hiring, compensating and training the replacement.

6. Estimate replacement contribution ratio

The contribution the incumbent would make to the firm expressed as a ratio of the contribution the key person made to the firm for each year of the planning period.

Based on the information gathered above we are now in a position to calculate the replacement cost of a key employee. We will use the information in the following case study as the basis for calculating the value.

Case Study

Mr. T, aged 39 is the top salesperson for GoldChain Corp. This is a small manufacturer and distributor of heavy 9ct. gold chains, rings and bracelets for men. The business is a family owned operation run by Ms. Astrid Goldfinger; Astrid is also the only shareholder. Her son Hugo runs the manufacturing plant and daughter Yvette is the chief purchasing agent.

Gross sales revenue for the year will be about \$C 2.5 million. This figure is expected to rise by about 8% for the 5 – 10 years. Mr. T is responsible for about 30% of the business's annual gross revenue. It is expected that this is a figure that will gradually increase to about 35% over the next few years and then level off.

You are informed that T's total compensation package for the year is \$150,000. This is a number that is expected to increase by approximately 10% per year for the next 3-5 years and then level off at a 6% increase.

Ms. Goldfinger estimates that if Mr. T were lost to the firm for whatever reason, it would take approximately three years for a new person to get to the point where they would be contributing as much to the firm as T currently does. You are also advised that the replacement would only be "worth" 25% of T's value in the first year but that the value would increase to 60% in the second year and be at 100% by the end of the third year.

When you ask what the costs would be to replace T you are advised that the direct costs would be as follows:

Search Costs	\$25,000
Relocation Expense	\$15,000
Signing Bonus	\$25,000
Total Compensation	\$100,000
Training	<u>\$25,000</u>
Total	<u>\$190,000</u>

You have been further advised that this amount would rise by approximately \$15,000 per year.

In order to perform our calculations we need one further figure. This is a discount rate to use in calculating present values. One number that you could use is the rate of return on the owner's equity (ROE) over the past 5 years. This has been 10%.

Where do we go next?

We have prepared a Key Employee Calculator to help you calculate the value based on the parameters just discussed.