



# Business Liability Funding – Utilising Life Insurance

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## Overview

In order to establish a Reasonable Basis for Advice in recommending Life Insurance to provide liquid funds to repay Liabilities, Financial Advisors need to correctly identify the particular Liabilities of the business entity.

Previously Advisors have relied on a “Rules of Thumb” or at best rudimentary un-substantiated Ratios. However in providing Financial Advice, Advisors must review the particular circumstances of a Client’s business in order to provide an appropriate solution for their Client’s circumstances. Furthermore underwriters require substantiation. Hence the importance of determining the kind of Liabilities.

In any business there are four kinds of Liabilities – Creditors, Borrowings, Provisions and Deferred income. If Financial Advisors can accurately identify the Liabilities in respect to a particular business an analysis of the quantum of Liabilities can be undertaken to determine the level of cover needed. Determination of the Liabilities can determine the quantum of Life Cover for the particular circumstances of the Client.

What follows is an overview of Short Term and Long Term Financing arrangements that

Principals of a business utilise which may require liquid funds to cancel Liabilities in the event of a contingent event.

## Short-Term Finance

Short-Term Finance has the following characteristics:

- It is typically repaid within one year,
- It is used to purchase/finance assets that will be quickly turned over in the business, such as trade debtors and inventory, and
- It is typically self-funding as it is used to purchase/fund assets that will generate the funds necessary to repay the loan when they are sold.

The main sources of short-term borrowing for businesses are Trade Credit, Inventory Financing, Overdrafts, Trade Financing and Accounts Receivable Financing.

## Trade Credit

Trade Credit is simply when a supplier grants a business an interest-free period before the business has to pay for the goods or services, for example a supplier may give the business thirty days from the date of delivery. Trade credit is usually relatively simple to obtain and, unlike bank loans and other forms of finance,



does not involve detailed loan applications or negotiations.

Businesses in any financial Lifecycle and especially in tough times make the most of trade credit. If the business has been granted thirty-day terms by a supplier the business may as well delay payment until the end of that period. An exception to this may be where the supplier has offered a cash discount for early payment, in which case the business should weigh up the relevant amount saved by accepting the discount.

### **Inventory Financing**

Inventory Financing is simply a bank line of credit secured over inventory. This makes the cash the business has tied up in the inventory more accessible to the business. This form of financing is obviously most useful for businesses with physical stocks of inventory and is therefore not useful for service firms. Lending institutions are typically only interested in corporate entities with solid track records. Inventory financing is also not recommended if stocks are comprised of obsolete or slow-moving inventories.

To maximise the chances of securing inventory financing the business will need to demonstrate that the business has good systems for maintaining information on inventory – stock levels, how old the inventory is, and costings. The lender will probably also want to see future orders for merchandise so they can be confident the inventory will move quickly, and may require an additional form of security, such as a Personal Guarantee.

### **Overdraft**

An overdraft or a short-term line of credit is an arrangement with a lender where the business may borrow up to a certain limit on a short-term basis. The lender will set a maximum negative balance, known as the overdraft limit. Borrowings can be made or repaid on a daily basis. The Principal of the business will be required to renew and renegotiate the overdraft annually. Repayments to the overdraft are flexible. It is important to note that an overdraft is repayable on demand although in practice a bank is unlikely to require this unless they are concerned about the business's performance. Overdrafts may be secured (for example, by a charge over the assets of the business or by offering personal security) or unsecured.

Overdrafts enable businesses to better manage cash flow. They usually carry a lower interest rate than credit cards but somewhat higher than bank loans for a specific amount and purchase. Interest is calculated daily on the amount outstanding, so the business only pays interest on the amount borrowed and only for the period the principal is outstanding.

Overdrafts, like bank loans, are usually only available to profitable, established businesses. They are useful:

- To even out cash flow when fluctuations are predictable, short-term or seasonal,
- For purchases that are too large for a credit card but too small for a bank loan (smaller amounts can be rolled into a cheaper form of



financing once a sufficiently large amount has accumulated),

- As an insurance policy in the event of a cash shortage, and
- To finance cost of goods for customer orders already received.

An overdraft is not advisable for purchases of major items of equipment. It is better to get a bank loan which has a lower interest rate and a longer time to repay the amount. It is also not a good form of finance when cash flow shortages may be permanent or for an extensive period, such as more than a year.

To establish an overdraft the business will be charged an establishment fee and a monthly administration or commitment fee. All legal fees associated with establishing the facility are also paid by the borrower.

### **Trade Financing**

Most banks also provide trade financing to cover the working capital gaps in import and export businesses. The term of such trade finance is for a period up to 180 days. For example, a manufacturer exports a shipment of nuts and bolts to Europe. His customers in Europe pay on delivery whereas his raw material suppliers in Australia are already owed their invoices. To cover the gap between the receivables on the goods shipped and the raw materials and other costs for producing those goods, a financier can extend a line of credit until the foreign customers have received the goods and paid their invoices.

### **Accounts Receivable Financing**

There are two methods of accounts receivable financing – Factoring and Lending.

- **Factoring** This is when a business sell accounts receivable at a discount to a lender known as a 'factor'. Factoring services are available from most large finance companies and also from specialist factoring business. The factor assumes responsibility for the collection of the business accounts receivable and advances the business a percentage of the value of those accounts. In most cases, a business would only be paid the balance of the accounts receivable, less the factoring fee, when the factor receives payment from the customer. It is important to note, however, that the business still bears the risk of bad debts. Not all small or medium-size businesses will be able to obtain factoring finance.

- **Lending** Most banks and finance entities will also lend a business funds using accounts receivable as security. Such financing entities will lend a cash advance of say 70 per cent of the invoices (debts over sixty days old are typically excluded). The lender will require the business to comply with certain debt collection procedures.

**Implication:** Unless the short term Financing arrangements are uncovered a possibility of a Funding Shortfall may occur.

**Action Required: Correctly identify all the Short Term Financing arrangements of the particular business Client including Trade Credit, Inventory finance, Overdraft Finance, Accounts Receivable, Finance including Factoring and Lending. Once the Short Term Financing arrangements are**



correctly identified the quantum of Total Financing can be determined.

### **Long-Term Finance**

Long-term borrowing is used to finance the purchase of Fixed Assets, such as equipment, motor vehicles, machinery and property, permanent increases to working capital, the acquisition of an existing business, and/or capital costs when launching a new business. The assets purchased using long-term funding need to generate a level of income adequate to cover not only the principal and interest repayments but also to earn a profit.

### **Types of bank debts**

Below is an overview of the three main types of bank debts – mortgage, personal loan and term loan.

- **Mortgage Finance**

Mortgage Finance is long-term finance for the purchase of land and buildings. Interest rates may be fixed or variable. Repayments are by regular instalments and include principal and interest. Interest-only loans are also available. Mortgages are secured by the property the business are purchasing. The term of a mortgage can run fifteen, twenty or thirty years. There are sources, including mortgage originators, brokers, building societies, banks, finance companies, solicitors' trust funds and insurance companies.

- **Personal loans**

Personal loans are repaid in regular principal and interest instalments. They are typically used for the purchase of motor vehicles,

shop fixtures or perhaps the initial stock. They are normally unsecured but sometimes secured against your life insurance policy. The term of a personal loan is usually three or five years. Most banks and finance companies offer personal loans.

- **Term loans**

Repayment of a term loan is typically by regular instalments of interest and principal. Interest rates may be fixed or variable. The loan may be interest-only, requiring regular payments of interest only with the principal repayment either made in a lump sum at the end of the loan term or refinanced with a new loan. These are usually used for the purchase of a business, land, buildings and equipment. Security is generally required. Term loans can run for any period between one and ten years. They are offered by banks, finance companies, building societies, insurance companies and solicitors' trust funds.

### **Hire Purchase and Leasing**

An alternative method for financing motor vehicles and plant or equipment is through a leasing arrangement. A key advantage of leasing is that it does not require the business to make a deposit upfront. The financier, known as the lessor, will buy the asset and then enter a contract called a lease under which the business, the lessee, have the right to use the asset for a specified period by making regular lease payments. The main providers of leasing facilities are specialist leasing companies,



finance companies, and some equipment or vehicle suppliers.

➤ **Hire purchase**

Under a hire-purchase agreement, the business will be required to fund a deposit and the balance outstanding on the purchase price will be funded by the financier. Repayment is by regular instalments of interest and principal. The financier retains ownership of the assets until all instalments have been paid. A hire-purchase agreement has the following characteristics:

- The term will vary with the type of asset being financed, but is typically three to five years.
- Hire purchase is used to acquire fixed assets such as motor vehicles, shop fittings, plant and equipment.
- The retention of ownership by the lender is effectively a form of security. If the business default, the financier may have the right to retain ownership of the asset.

➤ **Leasing**

A Finance lease is similar to hire purchase arrangements in that the ownership of the asset actually remains with the Financier or Lessor. The term of the contract is usually the asset's useful life. The Lessee will be responsible for servicing, insuring and maintaining the asset over the period of the contract. If the Lessee wishes to terminate the Lease early the Lessee may be liable for a penalty charge.

At the end of the period of the lease, the Lessee

generally has the option of returning the asset to the financier or offering to purchase the asset for its residual value (this will be a figure nominated in the lease).

If the Lessee returns the asset, rather than buying it out, the financier will sell it to the public and the Lessee may be liable for any shortfall below the residual value.

There are a number of other types of leases available, including:

- **Sale and leaseback package** – the Owner sell assets to the Financier and then leases them back. The key advantage of this approach is that the lease payments are generally tax-deductible. A common feature of these packages is a repurchase option at the end of the period of the lease.
- **Operating lease** – a short-term hiring arrangement that can be terminated without penalty and with short notice. For example, when you hire a motor vehicle, the rental company is responsible for insurance and maintenance and the business simply return it when the business is finished.
- **Fleet leasing** – may be a cost-effective option if a Principal needs a large number of vehicles. The leasing company will attend to the maintenance and management of the fleet.

**Implication:** Unless all the Long Term Financing arrangements are uncovered a



possibility of a Funding Shortfall may occur.

**Action Required: Correctly identify all the Long Term Financing arrangements of the particular business Client including Mortgage Finance, Personal and Term Loans, Hire Purchase and Leasing. Once the Long Term Financing arrangements are identified the Total Financing arrangement can be determined.**

### **Security for Financing**

Most lenders require loans to be protected by some form of security or collateral, such as a personal guarantee, a fixed or floating charge over the assets of the corporate entity, or a mortgage over the personal home. In general it does not matter how strong the business forecast cash flows are, the lender will usually require a tangible asset as security. In essence, the lender wants something valuable they can sell to cover the total amount of their loan in case the business fails or repayments cannot be made. For many people the most likely source of such security, in the absence of sufficient business assets, will be their family home.

Lenders usually seek to impose restrictions on the business to protect themselves against potential erosion of the value of the business or security through mismanagement during the term of the loan, such as:

- Providing the lender with regular financial status reports
- Preventing the business from borrowing further funds without approval
- Minimum levels of Working Capital

- Ensuring the business has adequate insurance
- Financial covenants, e.g. minimum earnings to debt ratios.

**Interest** The rate of interest charged can vary significantly between different lenders. Financiers apply a 'margin' to business loans to reflect the risk that they are taking on. The size of the margin typically ranges from 1 to 3 per cent depending on how risky they perceive the business venture over their cost of borrowing those funds. In turn this will be determined by the type and amount of security which is offered, the business experience in running a business of that type and the bank's view on the business risk arising from the nature of the industry, the financial trading record, spread of customers.

There are a number of different businesses that can review account statements to ensure that the business is not being overcharged interest or fees by the financier.

**Stamp duty** Bear in mind that if the bank takes security over the assets of the company or the home, the business may have to pay stamp duty. The rate is payable according to a cost scale that varies in each state.

**Services** The business should also ensure the lender offers the business a full range of services, such as linked cheque and credit card accounts, online or phone banking and leasing services. Some lenders will waive fees on other banking products, such as personal loans, if the business take out a business loan.



**Term** The term of a bank loan ranges from one to ten years and is usually matched to the useful life of the assets being purchased. The longer the term the greater the amount of interest charged. Note that early repayment penalties may apply if the business pays out the loan before the end of the term, particularly with fixed interest loans.

**Implication:** If the Principal of the business Entity cannot fund Financing Facilities in the event of a contingent event and provided it is possible in the circumstances consideration should be given to fund the interest component of the Short and Long Term Financing arrangements over a number of months.

**Action Required: Consideration should be given to calculating both the interest and the Short and Long Term Financing arrangements as well as a suitable period for the business to continue whilst the Estate is being wound up.**

### **Conclusion**

From the above it can be seen that an understanding of the Financing arrangements involving Short and Long Term arrangements will enable an Advisor to determine the quantum of cover needed to extinguish Liabilities including Debts. Once understood together with other Liabilities (not covered in this Strategic Update) the Financial Advisor will then need to carefully consider how to structure the quantum of cover required correctly.

For more information about how ili can assist you to adopt skills and implementation tools in respect to Estate Preservation Planning and business Succession Strategies please visit our website [www.ili.com.au](http://www.ili.com.au).

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