

The Synchron Guide to **BUSINESS RISK MANAGEMENT**

"No one plans to fail, but many fail to plan."





A lifetime of hard work, prudence and planning is rewarded by the accumulation of wealth. For more than one million Australians their wealth is generated by and locked up in their business. Insuring a house, car, jewellery and fine art is almost as automatic as breathing. Yet how many people fail to insure or properly protect what is really their biggest asset, the business, and the people who make up the business, which provides the income for everything else?

Spend just a few minutes reading this guide and you will discover how a modest outlay, itself generally a business expense, can save you financial hardship and even ruin.

Surviving a crisis

A business is essentially a group of people creating value. All businesses depend on a select few people; the owners and executives who provide the capital, generate the revenue, manage the daily affairs, plan for the future and create the profits. With small and medium size enterprises, unplanned events such as the sudden death, traumatic illness or total and permanent disablement of one of the principals can create hardship at a business as well as personal level.

Without prudent planning it can entail a collapse in the value of the business and its capacity to survive. For example, if one of the principals dies, will the surviving owners be forced into working with the family of the deceased and do those people have the skills and knowledge required to manage the business? Will they be contributors or passengers? Will the bank and other lenders or guarantors be satisfied that all is well or will they call in loans or terminate guarantees at the very time the survivors are least able to cope with the emergency?

Sound Business Risk Management removes all these anxieties. It is the means by which the business, (which is to say the surviving principals,) can survive a crisis. Its very existence is a re-assurance to shareholders, employees, lenders and creditors that is soundly operated, properly managed, trustworthy.

This guide outlines the three core areas of Business Risk Management that can be addressed with an effective life insurance program:

Key person insurance

Regardless of the worth of a business in terms of real estate, equipment and inventory, the biggest asset is its key decision makers. Without them the other assets are at best static. It is the people with the ideas, drive, initiative, skills and ingenuity who generate the profits and who ensure there will be profit tomorrow as well as today.

Asking this question of individuals can easily identify such people:

“Without him or her will there be a negative impact on sales, access to markets, cost savings, reputation, ability to raise capital or service loans?”

The managing director and other working directors are invariably key people. However, key people may not be on the board. They may be a financial controllers, computer programmers, specialist engineers and other technicians. People whose names, skills and personalities are a primary cause of sales and profits, together with non-executive capital providers such as silent partners.

The sudden loss of such a person has inevitable costs, not all of them obvious. As well as the fall in sales or profits, until a suitable replacement is found there will be recruiting, specialist training and familiarisation expenses. There invariably is a negative impact on capital value, goodwill and credit rating.

It may be thought that this is just part of business life and would occur

anyway with resignation or retirement. However, those life events have a lead-time that allows proper planning of adequate handover arrangements. Business insurance does the same thing for unexpected emergencies created by death, traumatic illness and total and permanent incapacity.

Who pays, who benefits?

A specialist risk adviser will first work with the designated executive(s) to identify key personnel. The financial cost incurred by abrupt removal will then be calculated and that person will be insured for an appropriate amount. Since it is the business which is being protected and which would receive the money, the business will beneficially own the policy and pay the premiums.

In calculating the risk the Adviser will take into account how much turnover the individual contributed (was it, say, 60% or 30%); how long will it be before that level of sales or cost efficiencies will be recovered and what other factors could have an impact.

Their role is to create a financial cushion and time to ensure business continuity.

While this guide focuses on providing for sudden emergencies, the costs of retirement or resignation can be offset with a fund that builds up liquidity to compensate for these costs when they occur. Ask your Synchron adviser for details.

The tax factor

The taxation implications depend on the kind of policy used, the particular circumstances and the method of ownership. This is a specialised field in which your Synchron business risk adviser will work with your accountant and provide a detailed analysis and recommendations.

In general terms, the main test will be the reason for an insurance purchase. Is it for revenue or capital purposes? With revenue purpose insurance the premiums are deductible and the proceeds assessable. With capital purpose insurance the premiums are non-deductible and the proceeds are usually non-assessable proceeds.

There may also be capital gains tax implications.

As with so much of Australian tax law, complexities abound. Your business risk adviser will work with and provide recommendations for you to discuss with your other advisers to ensure you obtain maximum business advantages.

Your adviser will also ensure that arrangements are formally documented with minutes or file notes to meet the requirements of the Australian Tax Office.



BUSINESS SUCCESSION PLANNING

If a principal or shareholder suffers a tragedy event, many people feel the impact:

The principals (directors, partners) and their families

The shareholders and their families

Staff and their families

Creditors, Suppliers and many others.

A business succession plan is part of a total business Risk Management plan. It enables a terminating principal to sell his or her part of the enterprise to the continuing owners (or others) and for them to buy it. It includes the basis of valuing a business and defines a funding mechanism.

The wisdom of making such an arrangement is self-evident. A few examples will suffice. If one of the principals dies, his or her estate may demand a payout of a size that forces the business to be wound up. Alternatively the heirs may insist on direct involvement in its operations even though they lack the necessary skills. Traumatic illness or disablement may inject an unacceptable level of uncertainty into the operation. The end result may be that outsiders have to be brought in at distorted values.

A formal agreement eliminates these concerns by creating ready buyers and sellers at a fair, pre-determined price, in the shortest possible time with the least personal stress and disruption to business.

In establishing such arrangements, the participants define the circumstances that would trigger it and the agreed value. They agree on the legal documentation required and establish a funding plan.

Insurance provides the cash required by buyer and seller alike when the trigger, event(s) occur. It minimises disruption, and avoids the necessity of additional borrowing or asset depletion in already adverse circumstances. It preserves values, and provides fairness and stability. As with key person insurance, its very existence is a signal to suppliers, customers and financiers that the business is prudently run and is to be trusted.

Key Questions

- How will there be an orderly and efficient succession that does not adversely affect the business?
- Will third parties end up with an unacceptable degree of control?
- If the principal dies, how are his or her beneficiaries protected?
- How will they ensure they get full value?
- Is an estate equalisation plan required to compensate disadvantaged family members?

Ownership

Business Insurance – Choosing The Approach

There are a variety of ways to structure ownership. They include the policies being owned by the Life Insured, Cross Ownership or an Insurance Trust.

What may seem the cheap option now may have considerable costs at the end.

We strongly recommend that ownership be properly structured from the outset to ensure certainty in the event an insurance claim arises or a succession agreement is activated. Your Synchron adviser will network with a specialist solicitor in this area to ensure the documentation is tailored to your requirements.

POLICY OWNERSHIP OF GUARANTOR PROTECTION INSURANCE

There are legal and taxation implications with ownership of a guarantor protection policy.

The business may own it and pay the premiums, which in effect makes the policy capital purpose key person insurance providing for debt cancellation. The correct ownership structure is essential because, if the business fails to the point of liquidation, the policy proceeds would be pooled with other assets to be shared by all creditors, meaning the guaranteed debt might not be repaid and the guarantor's estate could still be called on. There may also be capital gains tax consequences.

An alternative is for the guarantor to own the policy with the business providing a fee as compensation for the guarantee and the risk entailed. This combined with a formal agreement ensures that any proceeds would, indeed, be used to repay the debt.

Another alternative is for the policy to be owned by an insurance trust. This will ensure that proceeds are paid as intended, especially in the event of a terminal illness claim.

Much depends on the circumstances of your business and your co-owners, which is why your Synchron business risk adviser will prepare detailed, tailored recommendations to meet your individual needs and work closely with your accounting and legal advisers in the preparation of the appropriate paperwork.

THE BOTTOM LINE

This guide is only a brief overview. There are many issues you need to consider when you contemplate business risk management. At heart though, it is quite simple. There are some things you cannot prevent but which you can provide for. This is one of them.

No one plans to fail, but many fail to plan.

You have taken an enormous risk and applied a lot of time and sacrifice to build your business.

Why put your livelihood (and your family's) in jeopardy?

GUARANTOR PROTECTION

A director's guarantee is a pre-requisite for most business loans. What it means is the director has secured a loan with his or her personal assets. What it also means is that the guarantee is not extinguished until the loan is repaid in full (or revoked by the bank or creditor).

This means the lender may call on the estate of a deceased director. This is likely where one guarantor has more in assets than others. This is usually the case with family businesses and is therefore especially important.

As with key person insurance, the concept is simple and the advantages are self-evident. A guarantor protection policy ensures that on the death, traumatic illness or total and permanent disablement of a director/guarantor the debt is fully repaid. The business owners and guarantors are protected from the ramifications of providing guarantees when the business obtains loan money.

While this primarily benefits the guarantor and his or her estate in protecting personal assets, it has no less obvious benefits for surviving principals and shareholders. With the debt repaid, the business owners and guarantors are freed of further financial burdens at a time of stress.

The business risk adviser as part of a total package assesses guarantor protection requirements. It is quite common for what is known as joint and several guarantees to have been required. This means all guarantors are liable for the loan regardless of their share of the business or which principal took out the loan. Once again this may entail personal hardship for both the deceased family and surviving principals, and impact on the business capacity to continue and prosper.



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