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financial management

Guide To…

Protecting what's most important to your business

The most valuable asset of your business is the one that produces the most profit. Using this strategy can protect your business against the loss of its most important assets – your people. Whilst material assets can generally be precisely replaced, this is not the case in relation to human assets. In other words, good people can be hard to find.

The loss of a key staff member can have a substantial impact on profitability, operational management and the goodwill of your business. Many businesses find there are no replacements readily available within the business and it may take substantial time and money to find and train a replacement.

The provision of Key Person insurance can help fund such a loss by providing an injection of cash to help stabilise business capital or provide revenue.

How does the strategy work?

A "Key Person" in any business may generally be defined as one whose death or disablement would have an adverse economic impact on the business. The purpose of Key Person insurance is to provide a sufficient amount of money to offset the estimated loss to the business which will arise upon the death, disablement, or critical illness of that key person.

Key Person insurance may be used for either a revenue purpose (to protect against loss of income and profits), or a capital purpose (to provide funds to repay business debt) in the event of the key person's death or disablement.

Of course, alternatives to insurance, such as using savings, borrowing, or selling assets, may be available to protect your business. However, all of those options (assuming they are, in fact, viable in the 'real world') will cost at least 100 cents in the dollar. Key Person insurance costs a fraction of this amount.

The Benefits

A lump sum may be able to:

- offset a drop in your business's profits
- provide your business with sufficient time and inducement to find and attract a suitable replacement
- repay a called in loan
- protect your business goodwill and credit standing
- protect your business from a forced sale
- continue your business expansion or development plans.

Case Study

1. Protecting your business against a loss of profits

Charlotte ran a large and successful garden nursery for many years, employing a number of people. While she still owns the nursery, she has employed a manager, Gretel, to organise the day-to-day running of the business while she concentrates on her 'hobby' of splicing plants and creating new varieties for the nursery. Gretel's management nous has helped the nursery increase turnover and profits since she started work over three years ago.

Last year, Gretel was diagnosed with cancer and was advised to retire by her doctor. This has disrupted Charlotte's plans for a full retirement. Fortunately, Charlotte had the foresight to insure Gretel. The critical illness benefit has provided Charlotte with the necessary cash to find and attract a suitable replacement (who, so far has exceeded all expectations), as well as smooth over the inevitable drop in profits experienced as the nursery went through this period of upheaval.

2. Protecting your business debts

Adam has recently expanded his dry-cleaning business, funded by a loan from a major bank. As part of this agreement, Adam signed a personal guarantee encumbering his personal assets against the repayment of the loan. One of the conditions of the loan was for immediate repayment upon his death or permanent disability.

Adam realised that should one of these events happen to him, the options would either be to sell his business or the family home to repay the loan. Both of these options have significant drawbacks. Relying on selling the business assumes there will be a willing buyer at a reasonable price –the buyer, realising Adam's (or his estates) predicament may be able to force a lower sale price. Selling the family home also has the same problems, compounded by Adam's family having to find a replacement home!

Fortunately, Adam protected himself and his family by insuring himself for the value of the loan. Upon his death or disablement, he (or his estate) has the necessary cash to repay the loan and thereby extinguish the personal guarantee.

Tips and Traps

- It is essential to identify the key person or people whose loss would directly impact your bottom line.
- Term life insurance policies used to protect against a loss of profits are tax deductible (and any benefits received are assessable as income). These types of policies are known as 'revenue purpose' policies. You may consider increasing the level of insurance cover to account for anticipated taxes to ensure your business is left with the required 'net' amount.
- Term life insurance policies used to repay a loan or other debt are not tax deductible (and any benefits received are not assessable as income). These types of policies are known as 'capital purpose' policies.
- The Australian Tax Office does not see a 'revenue purpose' where the death or disablement of that person is likely to result in the closure of the business.
- Proper ownership of the insurance policy is vital. Different policy ownership may have different tax implications depending on the type of insurance and purpose of the policy.
- Ensure your insurance cover is updated in line with the (increasing) value of the key person to your business. Failing to do this may lead to a funding shortfall. You should consider insurance policies which allow you to increase the level of insurance cover in the future without medical evidence when the value of the key person to the business increases.

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.

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