

Applying for a loan

Information for small business

FACT SHEET June 2009

One of the key challenges for many small to medium businesses is working out how to approach the bank for a loan. Small businesses often look to finance their business needs with debt.

This fact sheet will discuss how small to medium businesses can plan to obtain bank finance. It was prepared by the Australian Bankers' Association and CPA Australia. For more information on sources of finance for a business please see Appendix 1.

To the point

- Your accountant and your lawyer can both advise you on your application.
- Banks will be happy to discuss your needs in a preliminary meeting.
- Make sure you take the necessary information required by the bank – relationships built on transparency do matter.
- Don't restrict yourself to one bank, shop around.
- Loan applications and shopping around take time, so it's best to schedule time to complete the task so you aren't rushed
- If you fail in your loan application seek feedback as to why it failed and what may be needed to be successful.

Understanding bank speak

Dealing with money and banking involves lots of words and terms that you might not have come across before. In this fact sheet, we provide a simple guide to some of the common words that you might encounter when dealing with your bank.

Risk

The meaning of 'risk' varies according to whether you are the borrower or the lender/investor. As a small business seeking a loan, risk would be the chance you take in borrowing money,

and being able to repay it. You may "risk" your business or even your family home to support your business finance opportunity. As a lender or investor, 'risk' means the gamble taken to support your financial opportunity, usually risking the repayment of the loan and the interest on it.

Security

In the legal sense, 'security' is a right against a particular asset belonging to another; for example, the banks may hold security over the home of a small business owner as collateral for a loan. A creditor without security has rights only against the debtor, not against any specific property.

Cash flow forecast

Sets out all expected payments and receipts in a given period. It is different from the projected profit and loss account, and in times of cash shortages, may be more important. This cash flow forecast also helps you to get a picture of the likely extent of a crisis and how long it might last. Forecasts should include all assumptions used to arrive at the projected cash flow, for example increased sales versus historical actual of say +10% and add in the reasons why.

Cash reserves

Cash put aside or kept back, sometimes for a special use.

Capacity to Repay

The determination made by a lender on whether a borrower can repay a loan after examining financial statements, financial ratios and operating data.

Credit History

A record of an individual's or company's past borrowing and repaying behaviour. Your credit history is contained in a credit file and it will include credit applications and enquiries you have made during the past five years; records of some



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current credit accounts; overdue accounts (defaults) which may have been listed against your name; bankruptcy information; judgments; and public record information such as Directorships and Proprietorships.

Interest cover

Determines the actual cash available to service the interest payable on the debt taking into account possible fluctuations in interest rates over the life of the loan and the making full use of the loan facility.

Loan to Value Ratio (LVR)

This is ratio that the Bank will lend against a small business asset. For example, if a factory is valued at \$500K at an LVR of 65%, then the bank may consider a loan/facility of up to \$325K.

Your bank is also a business

Your business needs to make a profit, so does a bank. When you approach a bank for financial assistance, you are asking the bank to go into business with you. You are asking the bank to consider your business plan, agree with your strategy, approve your expenditure and accept some of the risk that the business may not succeed.

Banks are in the business of supporting sound and viable financial decisions, therefore every request must be considered on its own merits.

Banks have to consider risk

The bottom line for a bank is: how much risk do we take on with this project? Will we make a profit, or are we more likely to make a loss? Each bank has its own guidelines to help it decide if a business proposition is worth pursuing or not.

Many of the applications a bank receives will not be approved, simply because the risk the bank is required to carry is too high, or because it believes the applicant can not support the risk either. Banks are regulated by the Australian Prudential Regulation Authority (APRA) which requires banks to make prudentially responsible lending decisions – the more risk the bank takes, the more capital it has to hold against that lending. Banks also quantify risk according to their own lending portfolio. A bank may decline to loan to a viable business based on the fact they are overexposed in the sector the business is in.

Understanding loan products

In a competitive market, banks will package finance products under different names and introduce a range of features to differentiate themselves. A description of the most common debt finance products is available at Appendix 2.

In matching a debt product and selecting the appropriate features to suit your business requirements, you need to

determine the following about your business:

- What the funds are going to be required for and how long do you require the funds for– for example, to fund the purchase of inventory or to fund a building extension?
- Be realistic about the amount of funds you require and can afford.
- What level of security can you offer? How will the bank view the value of the security?
- How will the bank assess 'risk' for your business?

How to appeal to your banker

So what is the bank looking for in your loan application? Three things – information, security and experience.

The more quality information the bank has about your business, your plans and your industry, the more likely you will be successful in your application.

The Loan Application Package

The objective of preparing a loan application is to show the bank that you run a viable business and therefore providing you with a business loan is a low risk proposition.

One of the most important aspects of your loan application is to demonstrate to the bank that you can organise your thoughts and ideas in writing and can support them with financial information. Make sure that you understand all the information that is being presented in the loan application.. Respect the bank's need to ask what appear to be personal questions. Remember, they are going to be your business partner!

Bankers will be very interested in how you run your business as a profit generating exercise and your plan to generate cash flow. Healthy cash flow is the very essence of a successful small business. After all if your cash flow is poor, your business will struggle to operate efficiently and repay any loan.

Security is also crucial to the loan application. The more security you have, the better your chance of getting a loan. The security you offer will form the basis of the loan agreement. Preliminary discussions with banks will give you an idea of the kind of security they would be looking for, and the dollar value of such a security.

Types of securities

Often small business people will offer their family home as security for a business loan. Depending on how much equity you have in the property, this may require changing your mortgage arrangements. The bank also wants to ensure you are committed to repaying the loan, so the requirement of security binds you to the business, and the bank.

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Alternatively, business assets may be provided as security in lieu of residential assets, at higher interest rates.

There also exists the option of a more expensive unsecured loan for small businesses that may be willing to pay higher lending costs in exchange for not risking their personal assets.

Banks may also ask business owners and directors of companies to provide personal guarantees (depending on the circumstances of the business) as part of receiving a loan.

A bank may also impose conditions on a loan, known as covenants. A covenant is an agreement between two or more parties that binds them from certain actions. For example, a borrower is bound to provide financial information to a lender, or is to refrain from incurring further debt during the life of the loan or to ensure that the Loan to Value Ratio (LVR) does not go above a certain percentage.

Lenders Mortgage Insurance (LMI) is required when the LVR exceeds a certain percentage for example 80%. LMI protects a lender when a borrower has an LVR that is greater than that percentage. Where LMI is required, a one-off premium is payable by the borrower.

Checklist for writing your loan application

1. Short written detail on the following:
 - a. What does my business do
 - b. Business history – including information on the business's past successes and depth of experience of the management or if a start-up, of the relevant successes and experience of the individuals behind the business
 - c. Industry information
 - d. Ownership details
2. Personal financial information – such information is relevant as it is likely that a bank will undertake a credit check of the business owners as well as the business. The types of financial information your bank may be looking for includes:
 - a list of personal assets
 - tax returns
 - personal banking details, including loans and deposits
3. Historical financial information - Where a business has been in operation, the bank will want to review historical financial information – typically balance sheets, profit and loss statements and cash flow statements for the past three years. Ideally, this information should be either prepared or reviewed by an accountant. Your bank is also likely to seek other data including BASs, current accounts receivable and payable schedules, bank statements etc.

4. Forecast financial information - The bank will require forecasts: cash flow forecasts, profit and loss forecasts and balance sheet forecasts. The forecasts should:

- be over the term of the loan you are seeking
- should state any assumptions you have made
- be written as if the loan application is successful
- the forecasts could include best and worst case scenarios.

5. Details on any sensitivity analysis and/or analysis of financial ratios. Your accountant should be able to help you with this.

6. Details on loan required - A detailed description of why the loan is required should be included in the application. This purpose will be critical in determining the type of loan you require. You should state the amount of the loan that you seek, why you need that amount and the term over which you seek that loan for. This will in part be determined by the type of loan you seek.

For most types of loans, banks require security over the loan. As part of your application, you identify the security you are prepared to offer. The value of the security should be greater than the value of the loan, and the value of that security should hold up over the term of the loan.

7. Business plan. Even if your business is already established, include a business plan as part of your loan application. This is the place to include your marketing plan and references to your major clients and suppliers.

Remember:

- Be sensible about the amount you actually need to borrow and be able to justify it.
- Take your time preparing the application and don't hurry the bank to make a decision.
- A well prepared business proposition is a good sign of a borrowers commitment to a prospective lender

Providing the information recommended in this checklist plus any additional information requested by your bank, will assist in the bank making a risk assessment of the business and decide whether to grant the loan.

Common mistakes that may hurt your application

It is likely that a loan application from a small business, with only a limited amount of security might be viewed with caution by the bank. However, there are steps you can take to maximise the success of the business proposal you are presenting to the bank, and these include:

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1. Don't Ask For More than You Need

Banks use a variety of formulas to work out how much they think you can afford to borrow. So it makes sense that you do not ask for more than you need to borrow, because the more that you request, the harder it will be to prove to the bank that you can afford to repay. It is also important not to underestimate what you need. If you do underestimate, you may need to go back to the bank to ask for more money.

2. Don't Rush It

Each bank will have different loan approval processes. The first bank officer or loan specialist you talk to may not be the person who makes the final decision on your loan. It depends on the size of the loan you want, the size of the bank and the systems the bank has in place for loan approvals. You are certainly entitled to ask how long the process might take, but avoid placing any pressure on the bank to respond. This will not hasten the process and may give the bank officer reason to be more cautious.

This initial person may have to present your application to a larger group for approval, so you need this person to be on your side, have all the information they need and a good understanding of what you want to do with the loan.

3. Common mistakes that small business make in the application process

- Thinking that business turnover (cash flow) reflects their actual profits. Banks look at net profits rather than cash flow.
- Not providing information about the directors of the small business. Banks will assess directors and may ask for guarantees from directors, depending on the individual circumstances of the business.
- for micro enterprises – thinking that business assets can be used toward security. While this can be considered for some business customers and corporate segments (if used as additional security rather than sole security), it is not acceptable by banks from the micro business segment.
- Inflating the value of business assets. Bank valuations assess standard market value for a quick sale therefore many small businesses overstate the true market value of their assets.

Presenting your business in the best light

A business plan and impressive financials probably will not be enough to secure you a loan.

At some point in the process you will have a face-to-face meeting with the bank to discuss the loan application and

possibly more than one meeting.

What the bank needs to find out at these meetings is whether or not you fully understand the implications of taking out the loan you are asking for. The bank will be testing to see if you really know your business, and the need for financing, as well as you say you do.

The bank will take into consideration the competitive position of your business within your industry and location, your enthusiasm for the project and your dedication to your business, but in the end, the bank wants to find out just how successful you are likely to be, and how likely it is that they will profit from your business success.

Before You Apply

Tips

Shop around

Most retail banks offer loans to the small business sector. They all have different products and services on offer. Make sure you shop around to find the right loan that suits your needs and consider whether it makes sense to consolidate your business with one bank to get the benefits of a package or have different providers for different products. You may also consider visiting a finance broker, as they can help a small business evaluate the options of many lenders.

Give yourself time to do some homework

The first aspect of the process is to find out what banks have to offer you. The bank you already bank with may not be the best for your business and may not offer you a loan. Do research, talk to other people in business, look at websites and gain plenty of background information about what all the banks offer. You do not have to confine yourself to a bank within your own town or region. Technology makes it possible for you to work with a bank based anywhere in Australia.

Timing

Don't wait until you are desperate to ask for money. This is not a good foundation for a successful loan application. The bank wants to feel secure in its decision. It does not want to hear that your business needs the loan to survive; it wants to hear that your business needs the loan to grow.

Find a specialist

Ask around; try to find out which bank has loan specialists who understand the industry sector you are in. Most banks have loan specialists who will have a better understanding of the sector you are in, which means they have a better appreciation of the conditions your business is exposed to. If you are a small business or a start-up, consider making your first approaches to banks with a small business focus or small

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business support already in place. Study bank websites to see which banks offer what kinds of business support.

Find the right tools

Some banks offer free software applications that can run alongside your internet banking. Such software may assist you to monitor your accounts, pending automatic payments, the exchange rate and more. Ask the bank during the application process if they have a particular banking service which may assist your business.

The interview

Presenting your business in the best light at a meeting, means presenting yourself in the best light. Remember: this is a business meeting. There is no reason to feel intimidated or nervous about asking a bank for money. They will want to do business with you, if your proposition is sound and your business knowledge and skills are apparent. If it will add to presenting your business in a sound light, ask your accountant or financial advisor to go to the meeting with you. Make sure the bank officer understands clearly what the involvement this person has with your business.

What if you succeed in your application?

If you have been successful with your loan application, this is not the end of the relationship with your bank. The process of providing information to your bank continues over the term of the loan. If the loan provided by the bank is more than \$1 million, banks generally carry out annual reviews. This usually happens either when your annual accounts are available or on the anniversary of the borrowing. At the annual review time you should be ready to provide all the information you prepared the first time. It is also likely that you will be called in for an interview.

For the relationship with the bank to develop well there is one requirement that must be observed, and that is that there must be a candid approach that involves keeping the bank properly informed. Any tendency to tell the good side and leave the bad side unmentioned should be avoided. Any downturn in events should be discussed with your bank manager as soon as it is known.

What if your loan application fails?

Banks do not approve all applications from small businesses, in fact up to one in four fail (depending on the prevailing economic environment). The reasons can be many and varied, so this is why it is important to seek feedback from the bank as to why. This feedback can provide some valuable insight into the weaknesses of the business and/or application.

Useful websites

Useful information can be found on the websites below:

Australian Chamber of Commerce and Industry (ACCI):

www.acci.asn.au

Business Victoria's Business Loan Finder:

www.business.vic.gov.au/BUSVIC/STANDARD/1001/PC_62522.html

CPA Australia:

www.cpaaustralia.com.au

Find a CPA:

www.cpaaustralia.com.au/apps/finder/cpa/showfind.aspx?CPSSessionID=SID-3F57FECA-ED7092D9

Council of Small Business Organisations of Australia:

www.cosboa.org

Australian Bankers' Association:

www.bankers.asn.au

Australian Bankers' Association website on small business banking:

www.smallbusinessbanking.com.au

Federal Government's gateway to information and resources about business:

www.business.gov.au

AusIndustry:

www.ausindustry.gov.au

See over for Appendices

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Appendix 1: sources of finance for a business

All businesses need finance to establish and grow. Finance can be provided from the following sources:

- Debt – this is financing that is provided from an external source, such as bank
- Equity – this is financing that is provided from an internal source, such as an owner or investor

Before applying for a loan, small businesses need to consider whether debt or equity or a mix of both is the most appropriate financing method your business.

The advantages and disadvantages of debt and equity finance can be summarised as follows:

Advantages	
Debt	Equity
<ul style="list-style-type: none"> • Retain control over the business • Opportunity for increased return on investment • Growth in value of the business is retained by the owner • Debt repayment commitment can be fixed • Lower cost of capital • Lower cost of raising debt finance • Interest expense is tax deductible • 15% • 20% 	<ul style="list-style-type: none"> • Ability to raise funds in excess of security • No exposure to changes in interest rates • External resources could add strategic input and alliances • Improved profile with lenders • Increased financial controls • More stable financial structure • Possible mentoring support from the investor as well as funds
Disadvantages	
Debt	Equity
<ul style="list-style-type: none"> • Ability to raise funds is limited by security available • Business may be exposed to financial risks as a result of interest rate movements • Reduced opportunity to establish new external alliances • Liquidity exposure of a highly geared structure • Business opportunities lost through tight cash flow • Profitability reduced by debt servicing costs 	<ul style="list-style-type: none"> • Loss of total control and autonomy in decision making • Greater pressure on achieving growth and higher returns • Need to identify exit strategy • Potential conflict between owner and investor • Additional costs of equity process • Greater management reporting required • Dividends are not tax deductible • Length of time to raise equity can be 3 to 6 months • Loss of retained profits if dividend payments are required

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Appendix 2: types of debt products

Short Term Funding

Debt Product	Description	Repayment/ Interest	Fees
Overdraft Purpose: Overdraft facilities are generally used to finance the day-to-day fluctuating cash requirements of a business.	<p>A facility that allows the customer to operate a bank account with a pre-agreed limit which can be drawn down.</p> <p>Overdraft accounts will usually only be provided to a business that has been successfully trading for a few years.</p>	<p>Overdraft facilities do not have a specific maturity date. The product is 'at call' or on demand, which means that the bank has the right to cancel the facility at any time.</p> <p>Interest is usually paid on a monthly basis. The rate of interest is determined in accordance with a risk margin that the bank will determine. The customer will only pay interest on the amount of the facility drawn down.</p>	<p>Generally include:</p> <p>Application fee - one-off fee to initiate the facility.</p> <p>Line or facility fee - generally charged on the available limit in arrears and is payable monthly or quarterly. Cheque account fees and transactional costs are also payable.</p> <p>Account keeping fees - charged monthly for operating the account.</p>
Line of Credit Purpose A line of credit is usually used to access funds for working capital requirements	<p>A line of credit or equity loan can provide access to funds by allowing the borrower to draw on an account balance up to an approved limit. As long as the balance does not exceed the approved limit, funds can be drawn at any time.</p> <p>These loans are usually secured by a registered mortgage over a property.</p>	<p>Repayments are usually required to at least cover the interest and fees on the loan.</p> <p>Interest is usually paid on a monthly basis. As this type of loan is usually secured against property interest rates tend to be lower than for overdrafts. However, if you fail to make your payments you can put your property at risk.</p>	<p>Generally include:</p> <p>Application fee - one-off fee to initiate the facility.</p> <p>Line or facility fee - generally charged on the available limit in arrears and is payable monthly or quarterly. Cheque account fees and transactional costs are also payable.</p> <p>Account keeping fees - charged monthly for operating the account.</p>

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Debt Product	Description	Repayment/ Interest	Fees
<p>Credit Card</p> <p>Purpose</p> <p>Credit cards should be used only to fund short term working capital requirements</p>	<p>Credit cards are usually offered on either 'Interest free days' or no "interest free days. They are generally easier to obtain due to the high fee structure and interest rates charged.</p> <p>The "interest free" cards generally carry higher interest, charged either from the day you purchased or from statement date unless you repay in full within the interest free period. Interest on cash advances applied immediately. They also tend to carry higher fees</p> <p>No 'interest free' days cards have a lower interest which is charged from date of purchase and generally carry lower fees</p> <p>Cards with an interest free period work best if you pay off your balance in full each month and avoid cash advances.</p> <p>The no-interest-free-period card will suit if you are unable to pay off your outstanding balances each month. Unfortunately, many people who don't pay their cards off each month have high interest cards and so pay more than they need to.</p>	<p>Credit cards usually have an expiry date, which indicates that, unless the facility is renewed, all outstanding amounts will be due by this date.</p> <p>Interest is generally either charged from the date of purchase of items or from the date your monthly statement is issued. For cash advances, interest is usually charged from the date of the withdrawal.</p>	<p>Annual account fees</p> <p>Fees to use rewards programs</p> <p>Fees for late payments</p> <p>Payment dishonour fees; and</p> <p>Fees for exceeding your credit limit.</p>

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Debt Product	Description	Repayment/ Interest	Fees
<p>Cash flow Lending</p> <p>Purpose</p> <p>This product is generally used for funding fluctuations in working capital.</p> <p>Best suited for service based or distribution businesses that do not have major investments in fixed assets. In addition, many manufacturing businesses use this type of funding.</p>	<p>A lending facility for small businesses that generate solid cash flow, but do not own significant fixed assets to provide as security.</p> <p>The loan is secured by working capital assets of the business, such as stock and debtors. The cash flow projections need to reflect the ability of the business to meet finance costs. Regular reports are required by the lender</p> <p>These loan facilities operate like a business line-of- credit facility, allowing you to draw down on funds as required.</p>	<p>The loan is similar to that of an overdraft facility in that it is approved for a specific term, with a regular review requirement.</p> <p>Interest is charged monthly on the daily balance outstanding.</p>	<p>Establishment fee - upfront fee to establish the line of credit.</p> <p>Service/administration fee - fixed or variable amount which is charged monthly or quarterly in arrears; based on the balance/ facility limit.</p>
<p>Debtor Finance</p> <p>Purpose</p> <p>This product can provide core working capital finance, as well as meet short-term fluctuating needs.</p>	<p>Debtor Finance may be known as Factoring, Business Growth Finance or Working Capital Finance.</p> <p>The funding is secured by the value of the amount owed by the businesses customers (debtors). The finance is generally available up to 70 – 90% of the book value of debtors.</p> <p>When the debtor is invoiced the financier will pay the agreed % of the invoice. When the debtor pays the balance of the invoice, the remaining percentage is received.</p> <p>The benefit to the business is that they do not have to wait until the customer pays before they receive their funds. This finance effectively shortens the cash cycle for a business. The funding is very flexible as it increases with the level of sales activity and is only utilised as required.</p> <p>Debtor finance does not always have to be disclosed to customers, as you still handle all debt collection and interaction with the customer. This product is now a more widely accepted form of finance to manage high growth and businesses with fluctuating activity</p>	<p>The debtor ledger value provides an upper limit of funds available. A business can repay part of the upper limit available.</p> <p>Interest is payable monthly on the funds drawn down, or alternatively, the financing company will take a percentage of the amount collected.</p>	<p>Establishment fee - upfront fee to establish facility</p> <p>Line fee - based on a percentage of the maximum facility payable monthly</p> <p>Administration/service fee - fixed or variable fee charged monthly or quarterly in arrears and based on the balance/ facility limit.</p>

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Long Term Funding

Debt Product	Description	Repayment/ Interest	Fees
<p>Full drawn advance</p> <p>Purpose</p> <p>This product is suitable for financing permanent or longer term funding requirements for property, plant and equipment or the purchase of a business</p>	<p>This product is a long-term loan that requires principal and interest repayments over the term of the loan. The term of the loan is generally between three to ten years.</p>	<p>A Fully Drawn Advance/Term Loan is provided for a fixed period. The loan is reduced by monthly repayments, which include both interest and principal components.</p> <p>The interest rate can be either fixed, variable or a combination of both. There may be penalties for early repayment if the rate is fixed.</p>	<p>Fees include :</p> <p>Application fee - one-off fee to initiate the loan.</p> <p>Monthly account fees - fixed amount per month.</p>
<p>Mortgage Equity Loan</p> <p>Purpose</p> <p>A long-term form of finance suitable for purchase of capital assets such as land and building.</p>	<p>A long-term loan where residential property is used as the primary source of security and the funds used in the business. In general, lenders will lend up to 80% of their value of the residential property.</p>	<p>The term of the loan is fixed. Repayments will involve both principal and interest.</p> <p>Interest can be based on fixed or variable rates or a combination. It may also be possible to have a combination of fixed and variable or a capped rate, which provides protection to borrowers where changing rates have reached the cap rate.</p>	<p>May include:</p> <p>Establishment fee - once-off fee to establish the loan.</p> <p>Administration service fee - either fixed or variable based on the balance/facility limit or invoice amount, charged monthly or quarterly in arrears.</p> <p>Document fees - fees to cover mortgage registration, property valuation, legal fees and stamp duty</p>
<p>Interest Only Loan</p> <p>Purpose</p> <p>Generally used for medium term funding requirements and is often suitable where cashflow is tight at the start of the business.</p>	<p>An Interest Only Loan involves the lending of a fixed amount for a specific period, where only interest payments are required to be met during the term of the loan. The principal is due on maturity of the loan. The loan is generally secured by property or business assets.</p>	<p>The loans are generally for a period of 1 to 3 years. The principal is due on maturity. The loan may be rolled over into a principle and interest type product at the end of the term.</p> <p>Interest is generally paid on a monthly basis based on the full amount of the loan.</p>	<p>Establishment fee :</p> <p>up front fee to establish the loan</p> <p>Administration/service fee: charged monthly or quarterly in arrears and is either fixed or variable and based on the balance/facility limit or invoice amount.</p>

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Debt Product	Description	Repayment/ Interest	Fees
Chattel Mortgage Purpose Chattel mortgages are used for financing assets such as motor vehicles and plant and equipment.	A Chattel Mortgage or Bill of Sale is a loan agreement in which you borrow funds to purchase equipment. The borrower provides security for the loan by way of a mortgage over the equipment financed. If the borrower is a company the product will be a Chattel Mortgage and if an individual, it will be a Bill of Sale. Under this finance the equipment/ asset will be owned by the borrower and they would expect to be able to claim the full amount of the GST as a capital acquisition on purchase of the capital item.	Chattel mortgage finance is generally over a three to five year period. The repayments are usually on a monthly basis and include components of interest and principal over the term of the product. At the end of a finance period there is usually a capital residual to be paid.	Chattel mortgages usually require stamp duty on the finance arrangement. No other fees are applicable.

Internet: www.bankers.asn.au

Phone: 02 8298 0417

Fax: 02 8298 0402

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