INDEPENDENT INSURANCE AGENTS & BROKERS OF LOUISIANA
9818 BLUEBONNET BOULEVARD
BATON ROUGE, LA 70810
PHONE: 225/819-8007
FAX: 225/819-8027
www.iiabl.com

Technical Advisory

TA 242 **September 30, 2004**

Subject: Agency Financials – The Importance of “Staying in Trust”

Background: Agency consultants and accountants use the term “staying in trust” to measure the short-term financial solvency of an insurance agency. It is estimated that as many as 40% of agencies nationwide are not in trust, posing potentially serious problems for the financial health of the agency.

A commonly used formula is [Trust Ratio = Cash + Cash Equivalents + Accounts Receivable divided by Accounts Payable]. An agency with a trust ratio below 1.0 is “out of trust.”

Although being in trust is not a legal requirement in Louisiana, as it is in some states, most insurance company contracts require agencies to be in trust.

In addition, being out of trust can have a negative impact on an agency’s valuation at the time of sale or merger.

Agency consultants frequently report that accountants they deal with in the course of their consulting work often do not know the importance of the agency trust ratio. Often, the consultant and the agency owners are left to educate accountants on this important issue.

Main Points: Reprinted below is an excellent article by Chris Burand of Burand & Associates, one of the best agency management consultants in the country. Chris has many agency clients in Louisiana, and he has also done many seminars for IIABL over the years.

<u>"Stay In Trust To Stay Out Of Trouble"</u>

By Chris Burand
Burand & Associates, LLC
Pueblo, Colorado
Phone 719-485-3868
chris@burand-associates.com

<u>Part One</u>

Is your agency in trust? Use the following formula to find out: Trust Ratio = Cash + Cash Equivalents + Accounts Receivable (dollars collectible from companies and customers/Accounts Payable.

If the result is 1.0 or greater, your agency is in trust. If it isn't, your agency is out of trust, and you should work to bring it into trust.

Why is it important to be in trust? First, in some states, being in trust is a legal requirement. Second, virtually every insurance company contract requires you to be in trust. If you are out of trust, companies can immediately pull your contract. Third, being out of trust may be considered fraud. Technically, the agency has spent someone else's money, funds it was supposed to be holding in a fiduciary account.

These are powerful reasons for being in trust. But evidently, they are not powerful enough. I've seen estimates that more than 40 percent of agencies are out of trust. My personal experience confirms that many are.

Why are so many agencies out of trust? Perhaps because no authority regularly audits agencies' books, except in a couple of states. But even if the rules against being out of trust are not widely enforced, breaching them can have grave consequences. Consider the following:

- A disgruntled employee disclosed to authorities that the agency he worked for was out of trust. The agency owner lost his agency.
- Companies are going to increase the financial standards that agencies must meet to get and keep their contracts. Already several top companies -- the kind of companies all agencies want -- have raised their requirements. Companies are realizing that it is in their best interest to do business only with stable, well-managed agencies. That means agencies that have strong balance sheets, of which a good trust ratio is an integral part. Agencies that are out of trust will be stuck with lesser companies.

Most agencies that are out of trust also have too little working capital. Many agency owners drain their cash coffers every year to avoid double taxation (i.e., having the cash subject to corporate taxes, as well as personal taxes). That's fine if the practice is done within reason. The problem is that many owners take out way too much. They do not

leave enough cash in the agency to fund future growth or emergencies. Agencies should maintain at least 30 days of working capital in the bank. In fact, many agency-management authorities believe that figure should be increased to 45 to 60 days of working capital.

In the past, agencies did not need significant cash reserves. In the past, however, agencies did not have to make significant outlays for information systems, acquisitions could be funded out-of-pocket, and producers came somewhat trained from companies. None of that is true anymore. Indeed, the best new producers are "home-grown" right out of college. As a consequence, agencies need a lot more cash to fund these expenditures.

Poor working capital and inadequate trust accounts also affect agency values. Most educated buyers require a selling agency to be in trust and to have at least 30 days of working capital. Many selling agency owners have been unpleasantly surprised to find they have to take a big cut on their price because their trust ratio is less than 1.0. For example, let's say an agency is worth 1.3 times revenues. If the agency is out of trust by $100,000 and has $750,000 in revenue, that agency is not worth $975,000 (1.3 x $750,000). At best, it is worth only $875.000 ($975,000 - $100,000). Most buyers will make additional deductions because they have to make up the working-capital deficit with after-tax dollars. Therefore, the agency could be worth as little as $800,000, or 1.07 times revenues.

I have witnessed many sellers' severe disappointment when they realized their agencies' values were sharply reduced by a lack of working capital. Being in trust and having adequate working capital are rarely discussed in regard to agency values, especially when multiples like 1.5 to 2.0 times are bandied about without mention that those multiples assume adequate working capital. Without adequate working capital, huge deductions apply to these multiples -- especially if the agency is out of trust. I've seen agencies lose half their value for being out of trust. Imagine working 30 years to build your agency and discovering it is worth only 0.7 times revenues. What a horrible discovery!

Two common misconceptions exist regarding being in trust and working capital:

- First, that an agency is in trust if it pays its companies on time. This is not necessarily true. To be in trust, the agency's trust ratio (described above) must be greater than 1.0.
- Second, that minimizing taxes is always a good strategy. It is *if* adequate working capital and trust ratios are maintained. Agency owners often believe that their accountants understand this caveat when they render tax advice concerning how much cash to leave in the agency's accounts. Many accountants however, do not know our industry well enough to understand the importance of working capital and trust ratios. Agency owners must educate their accountants to ensure they receive tax advice that will not jeopardize their agencies' financial health.

Get and stay in trust! It is vital to your agency's success.

Part Two

Are you at Risk?

If you are following the trade press regarding the investigation of Near North Insurance Brokerage for embezzling premiums, I think several points are well worth noting.

Near North is in Illinois, a state that requires agencies maintain a trust fund. However, the charges are federal. Their bookkeeper pled guilty in March 2004 to federal charges, not state charges. Also note that as Business Insurance reported on March 29, 2004, the federal prosecutors charged that "By using the premium fund trust account "as his personal piggy bank," [the agency owner] was able to expand his business, toy with business ventures with virtually no fear of risking financial failure, and gain access to large sums of cash for personal expenses for himself, his family and others."

This sounds like a charge that could be brought against a lot of agency owners. Agency owners, and their CPA's, often tell me after I advise they are out of trust, that their state is not a "trust state" and therefore, being out of trust is not an issue. I am not an attorney so maybe there is some peculiarity to Near North's case, but those are federal charges. It seems like federal charges will trump state charges since all agencies are involved in interstate commerce and therefore, whether the agency is in a "trust state" or not is pointless.

If I've caught your attention now, you probably need to talk to your accountant. Most agencies' accountants never discuss the need to stay in trust. Instead, they only talk about tax minimization strategies. If an agency minimizes its taxes too much, it will inevitably go out of trust and in fact, that is how most ended up out of trust anyway. Every agencies' tax minimization strategy should be balanced with staying in trust (a trust ratio of at least 1.0 and for safety, a 1.1 ratio is even better). Make sure to discuss this with your accountant.

Part Three

An agency valuation I completed a few weeks ago was considerably less than the agency owners expected. The reason? Their balance sheet was very poor and they were materially out of trust [meaning (Accounts Receivable + Cash)/Accounts Payable was less than 1.0]. They were quite upset that I would decrease their value for this reason. They retorted, “We always pay our companies on time, our companies have

never been hurt by this, our customers have never been hurt by this, and our CPA has never found fault with this practice. You are the only one that thinks it matters!"

As it happened, this particular agency was also located in a state that legally required agents maintain a trust fund. Even so, this is an issue for all agencies regardless of their state law because, remember, Michael Segal, principal of Near North Insurance, was convicted in FEDERAL COURT of fraud and racketeering charges in June 2004 for violating his brokerage's trust account. As the U.S. Attorney's office for the Northern District of Illinois stated, "We think it sends an important message to those who are trusted with the fiduciary duty of holding other people's money that there are serious consequences to violating that trust and duty." (*Business Insurance*, June 28, 2004)

Mr. Segal's defense "contended that Mr. Segal was a victim of bad accounting at the brokerage and that no insurer or customer was ever harmed." (*Business Insurance*) Doesn't this latter part of the rebuttal sound familiar? In fact, I have heard the very same argument from very many agencies. I have not seen any evidence suggesting that Mr. Segal's companies were not paid or that his customers were harmed, and yet, he was convicted. The point is not whether the companies or customers were harmed but rather, the money was misused. When customers pay for their insurance, that money should not be used for any other purpose, whether that purpose is to buy other agencies, make payroll, or improve one's lifestyle. Even if the agency owners must pay higher taxes by leaving money in the agency so the agency's trust ratio remains above 1.0, the money should remain and the taxes paid.

I have seen several articles written by other consultants estimating 40%-50% of all agencies are out of trust. My experience suggests they are correct. Why should an agency that has obviously misspent its clients' money be valued as highly as one that has not? One way or another, the agency will have to pay the money back. If not before the sale, then every halfway intelligent agency buyer is going to deduct enough from the price to get the agency into trust upon acquiring the agency.

I strongly encourage every agency in every state to get into trust as soon as possible. There are several ways to do this. The fastest is to get a long-term loan equal to the deficit and put the cash in the bank and leave it. Then pay off the loan.

An alternative is to budget $x per year to the agency's capital account until it is in trust. For example, suppose an agency determines it should leave $50,000 cash in the agency every year until it gets into trust. To leave $50,000, the agency must record profits of approximately $87,000 at a 34% tax rate. Therefore, it must adjust its budget accordingly so that its profit at year-end will be at least $87,000 after every single other expense, including all owner compensation. Sometimes this means owners must take pay cuts, which is always hard to swallow. However, another way to think of it in some situations is that the owners would not have made as much in past years if they had not paid themselves from the trust funds anyway, so this is just repaying the loan.

My clients noted their CPA had never advised them about being out of trust, and in fact when their CPA called me to learn about trust ratios, he advised that he did not think they were that important. And indeed, I can see his point since insurance agency trust fund questions do not appear on the CPA exam. Since he had also not read state insurance laws, insurance company contracts, insurance agency ethics, or any recent editions of major insurance industry trade press, he could claim ignorance.

Agency owners beware! Unless you ask your accountant very specifically for advice on these issues, they will not advise you on them. They will just focus on minimizing your taxes, which in turn, will almost inevitably put you further out of trust!

Many agency owners have advised that since their states do not mandate they maintain separate trust accounts, being in trust is meaningless to them. I am not an attorney so I cannot offer a legal opinion. However, I do know the following: the insurance company contracts often require being in trust, ethically it is the right thing to do, and Mr. Segal was convicted in FEDERAL COURT! Nearly everyone reading this probably lives in the United States and does business across state lines (since your companies are located in states other than yours). Maybe it is time to reconsider whether being in trust applies to you.

Necessary Action: Circulate this Technical Advisory to all appropriate management staff.