TECHNICAL ADVISORY

INDEPENDENT INSURANCE AGENTS OF LOUISIANA

TA 177 **January 19, 2001**

SUBJECT: **"Stay in Trust to Stay Out of Trouble" (Chris Burand)**

BACKGROUND: The phrase, "staying in trust," refers to the short-term financial solvency of your agency. Consultant Chris Burand cites that as many as 40 percent of agencies nationwide are not in trust, posing potentially serious problems for agents.

MAIN POINTS: By using Burand's formula [Trust Ratio = Cash + Cash Equivalents + Accounts Receivable (dollars collectible from companies and customers) ÷ Accounts Payable], you can determine if your agency is in trust. Any agency with the capability of scoring 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. It should also be noted that accountants may not know the insurance industry well enough to understand the importance of working capital and agency trust ratios. You must educate your accountants regarding these matters so that they can be considered in combination with good tax advice.

Attached is Burand's informative article which addresses in depth this important issue.

NECESSARY ACTION: Carefully review this article and share it with any other principals in your agency.

STAY IN TRUST TO STAY OUT OF TROUBLE

By Chris Burand

(Reprinted with permission from the December 2000 issue of American Agent & Broker)

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 mulitples 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.

Chris Burand is president of Burand & Associates, LLC, a consulting firm. You may contact Chris by telephone at (719)485-3868, by fax at (719)485-3895 or by e-mail at chris@burand-associates.com.