OPTIS PARTNERS, LLC
CONSULTANTS TO THE INSURANCE DISTRIBUTION SYSTEM

Managing Your Agency's Financial Information

BY DANIEL P. MENZER

Your agency has access to an impressive array of financial reports and ratios that can be produced by your agency management system and related spreadsheet analysis. You can also incorporate financial standards, benchmarks and other measures to track and analyze your agency's financial condition. But too much information can be just as paralyzing as too little – and serious problems can arise if you pay too much attention to the wrong data. How, then, do you identify the financial information most important to the management of your business?

Every agency differs in its financial position and the factors that got it there. Internal issues, such as a recent acquisition, can place strains on an agency that are far different from those stemming from the loss of a major account. In contrast, external issues, such as the soft market and current economic malaise, appear to affect everyone similarly, but differences are often revealed when an agency evaluates its current financial status and contemplates how to react.

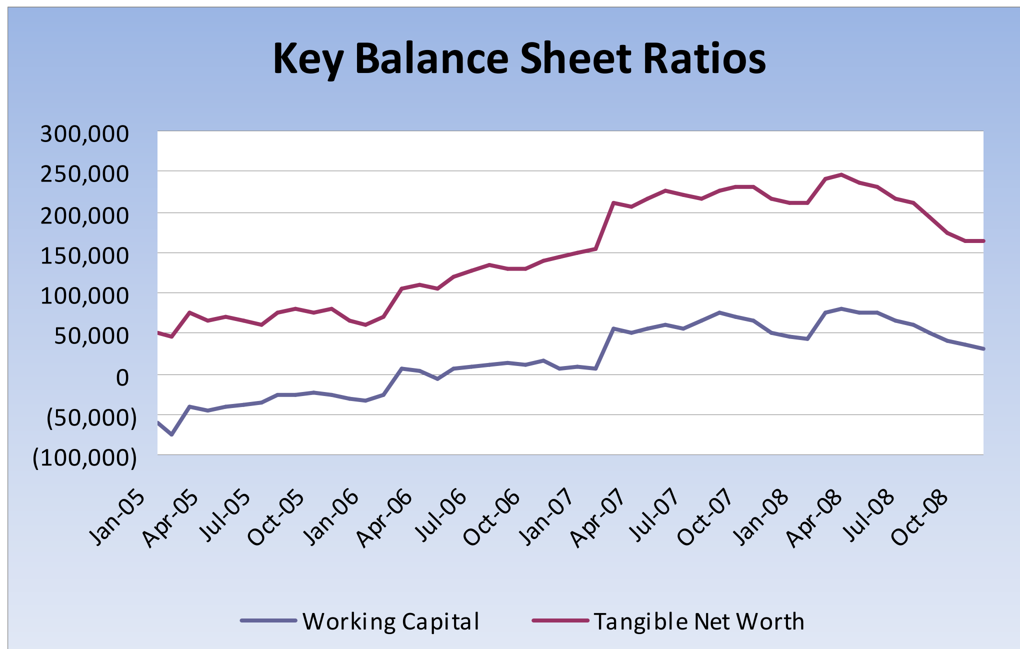
To manage your agency's finances as well as possible, consider taking three key steps:

- Create your financial report card
- Create a financial plan
- Remember liquidity, stability and validity when it comes to your balance sheet.

Creating your financial report card

Public brokers disclose their results every quarter, and annual rankings of agencies and other information provide a degree of financial performance comparisons against your peers. Although these are valid sources of information and should be included in your financial planning process, they reflect business operations different from yours, and should not necessarily be viewed as the ultimate model for analyzing your own agency. (See Exhibit A for a list of some of the most critical financial ratios to be included in your own agency analysis, as well as in peer comparisons.)

Many times, the best measure of an agency's performance can be found in comparisons to itself. Has your agency's financial condition shown improvement or deterioration over time? Has profitability improved year over year? Has working capital deteriorated over the past 12 to 24 months? Only by studying your own agency's financial health over the years will you be able to judge whether your situation is improving, worsening or remaining unchanged. As illustrated in the chart below, the ability to see trends and changes is made much easier with the availability of charts showing multiple periods of data:



Identifying appropriate financial attributes to review is a process best undertaken by the agency's senior financial officer. The CFO should examine a variety of internal and external peer information, including revenue ratios, compensation measures, expense comparisons and balance sheet factors. These calculations should be used to help set parameters around results that are normal for your agency. They should then be compared with the agency's historical results to identify unfavorable trends or situations, and provide information relative to industry standards and peer data. Critical items and any areas outside the normal range should be included in metrics reported to senior management to facilitate understanding of the agency's overall financial picture, and to aid in the development of corrective actions.

While it's prudent to review a variety of ratios, trends and financial measurements, not all of them will require management's attention. Senior management should focus first on the ones that produce the most significant impact to the agency, as well as those that management has the most ability to change, such as compensation measures, T&E expenses, and receivable collections. Trying to manage and improve too many situations at once can stretch resources too thin and result in few things getting done well or at all. It's also important to note that while some financial measures may fall outside the norm, either the cost of the solution or the value to be gained from it may not justify the resources needed to remedy the problem.

Nonetheless, the onus is still on management to identify areas that can be improved and then to design and implement corrective measures. This may involve finding new ways to accomplish certain tasks, either with technology, process improvement or outsourcing. Examples might include utilizing the agency management system differently to improve customer file information, developing new financial reporting tools or identifying tasks within the agency (i.e., licensing, insurance certificates, cash receipt processing or many others) that outside resources can handle more cost effectively. The good news is that in many situations, the mere act of management's disseminating information and sharing concerns about performance measures can have a favorable influence on staff members, negating management's need to implement drastic measures.

Creating a financial plan

Obviously, you should be in the business of growing your organization and creating more profit for its owners. Without proper means for evaluating results, however, you won't know if you're really accomplishing your goals. And if you haven't set goals, you certainly won't know whether you've made real progress. A major step in managing the agency's financial results, then, is to create a budget, set goals for the year and review the agency's performance against the goals on a regular basis. A meaningful financial plan will not just be a one-page projected income and expense budget. Instead, it should include these key attributes:

- Specific goals and objectives set forth by management
- Detailed revenue projections from each producer for each client
- Projections for new and lost business from each producer, and external market-renewal pricing factors expected to influence revenues
- Separate compensation plans for customer service employees, producers, managers and owners
- Operating expenses built from the ground up, including any discretionary owner expenses as a means of isolating non-critical company expenses
- All capital needs of the agency, including new technology, facilities and furniture
- Assessment of long-term needs in personnel, such as additional sales staff, loss control experts, claims or client advocates and additional management depth.

When your financial plan has been completed in accordance with the requirements established by management, agency leaders should participate in regular financial reviews of the results and selected ratios or other financial measurements identified as requiring attention. Through the review process, management needs to understand the underlying causes of variances so appropriate actions can be taken. As an example, if revenues are well ahead of budget, but solely because the agency's largest client financed its renewal and paid it all upfront, this isn't really a positive variance toward the overall goals of the agency.

Staying close to your balance sheet

Most budgets and financial performance measurements focus on the income statement and profitability. Although profit creates the financial growth of the organization, all can be lost with a few missteps without proper care and management of the balance-sheet components. Unlike many other businesses, insurance agency/brokerages typically capture less than 10 percent of the gross flow of funds on the income statement. This means that the other 90 percent must be monitored and managed through the balance sheet. This is particularly noteworthy in light of the bad mortgages, consolidated debt obligations (CDOs) and other losses that came to light in 2008 in the financial industries. Valuation problems, such as delinquent receivables, debit payable items and others in an insurance agency can go undetected on the balance sheet for long periods of time, and management needs to be diligent in their oversight.

As mentioned earlier, there are three terms associated with an agency's balance sheet that management should consider as part of its financial planning and oversight: liquidity, stability and validity.

Liquidity is the measure of an organization's ability to easily convert their net assets to cash. For an insurance agency, this is typically measured through calculations such as the current ratio, trust ratio, receivable ratio or working capital. These calculations are all designed to help management evaluate the organization's ability to meet current obligations, such as company payables and expenses, from current resources (i.e., customer receivables and cash). Buyers of

agencies typically require at least 30 days' worth of working capital to be on hand at closing. If the amount of working capital in your agency is substantially less, you may want to consider steps necessary to increase the working capital balances in your operation.

Stability is a measure of an organization's ability to withstand unforeseen adverse events, both internal and external. Soft markets can create prolonged strains on an agency's finances if they aren't adequately prepared. Death, disability or long-term illnesses of key agency personnel can create disruption and uncertainty with clients, markets or internal resources. Bad debts, E&O claims or other unexpected demands on agency resources create direct financial losses to the company. Without sufficient financial capital and resources to absorb these types of situations, the agency may not be able to meet its financial obligations and continue in existence. Sufficient working capital and tangible net worth, as well as the ability to access funds from owners, investors or lenders, are all examples of stability measures.

In many situations, owners distribute most or all of an agency's profits to avoid double taxation at the corporate level and personal level, or to push the income from business to personal accounts. Both of these approaches generally make sense. But when the liquidity of the agency is distributed to the owners with the idea that if the agency ever needs the cash, the owners will be able to put it back in, what happens when the owners' liquidity position doesn't allow for the agency's needs? Case in point: If agency owners needed to inject capital into their agencies in the current economic climate, with the stock market lingering at multi-year lows, home values sliding backward and possibly underwater now with mortgages, where will the owners find liquidity to support the agency?

On the other hand, if the agency retained some level of profits each year to maintain and improve its working capital, tangible net worth or borrowing capacity for a "rainy day fund" or upcoming investment requirement, albeit with some level of incremental taxes involved, the agency would be much better prepared for liquidity needs when they arise.

Validity is the measure of accuracy or proper valuation of the reported balance sheet amounts. While the agency may have great financial ratios, working capital and tangible net worth, if the balances shown on the financial reports are not accurate or collectible, the financial measurements may be meaningless. Examples: bank accounts with improper adjustments or reconciling items, receivables with a substantial amount of uncollectible balances, premiums payable, including funds due from insurance companies unable or unwilling to submit the return premiums the agency believes are due, or someone intentionally or unintentionally causing a misstatement of certain accounts within the balance sheet. Any of these situations can leave management with significant financial exposure, despite all calculations being favorable.

To avoid unexpected problems from the balance sheet, management should establish prudent targets for liquidity levels and stability measures, and then verify the integrity of all balance sheet accounts and balances via thorough reviews of supporting documentation and reconciliation schedules.

In today's world of full disclosure and transparency, the objectives addressed here shouldn't apply only to your dealings with the agency's customers and insurance companies. Management needs to know where the business stands financially at any point in time, and where they want it to go. They also need a means of measuring their success. They need to evaluate whether they are progressing toward their strategic and operational goals without undue interference from

tax strategies, and whether the financial position reflected on the balance sheet is accurate. In essence, management should be able to provide direction and oversight to the financial operation of the agency without getting too involved in the details.

Thus, critical steps are:

- Identify financial situations trending in the wrong direction, outside the norm or inconsistent with management's overall strategic direction of the agency.
- Select the most critical and/or problem areas that have the greatest potential returns.
- With input from staff members affected, craft feasible changes and implement them to remedy the situation.
- Establish financial goals and objectives in the form of a budget.
- Create the necessary reporting mechanisms to allow meaningful analysis and oversight on an ongoing basis.
- Manage the balance sheet's liquidity, stability and validity to avoid unpleasant surprises.

Dan Menzer has specialized in the finance roles within the P&C insurance world throughout his career, working in public accounting (KPMG), insurance companies (The Hartford Insurance Group), insurance brokers (A.W. Lawrence and Arthur J. Gallagher & Co.) and a financial consulting firm (Marsh, Berry & Co.) before joining OPTIS Partners in 2008. He can be reached at ***menzer@optisins.com****, or find additional information about Mr. Menzer and OPTIS Partners by visiting their website at* ***www.optisins.com.***

© *American Agent & Broker,* March 5, 2009

Exhibit A **Key Financial Ratios**	IIABA Best Practices (1) (Average)	Today's Target Ratio
<u>**Income Statement Ratios:**</u>		
Revenue Ratios:		
1. Total $ Revenue growth		
2. % Rev Growth	6.4%	> 0%
3. Comm & Fee $ Growth		
4. % Growth in Comm & Fees	5.7%	> 0%
5. Contingent Commissions / Prior Year Commissions	10.6%	> 5%
Compensation Ratios:		
1. Producer comp (#) / Net comm & fees		< 30%
2. Chg in producer comp / Chg in Comm & Fees		> 30%
3. Admin & mgmt comp (#) / Net revenues		< 27%
4. Total Compensation (#) / Net Revenues	57.9%	< 55%
Other Expense Ratios:		
1. Selling Expenses / Net revenues	3.0%	< 4%
2. Rent & utilities / Net revenues	4.3%	< 4%
3. Operating Expense ratio	14.9%	< 15%
4. % Change in Non-Compensation Expenses to % Change in Net Revenues (*)		< 1.0
Income Ratios:		
1. (Pre-tax Income (#) + amortization) / Net revenues	20.9%	> 20%
2. % Growth		> 0%
3. EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization) / of Net Revenues	23.5%	> 24%
<u>**Productivity Ratios:**</u>		
1. Revenues / Headcount	$ 153,607	> $100,000
2. Compensation / Headcount	89,063	
3. Spread per Headcount	64,544	
4. Avg Fully Validated P&C Producer Books of Business	343,538	> $350,000
5. Avg Commercial CSR Book of Business	257,699	> $250,000
6. Rent & Utilities / Headcount		< $5,000
<u>**Balance Sheet Ratios:**</u>		
1. Working Capital (WC)		
2. # Days of Working Capital		> 20
3. Current Ratio	1.46	> 1.1
4. Ratio of Customer Receivables to Premiums Payable	0.61	< .70
5. Ratio of Cash + Customer Receivables to Premius Payable		> 1.1
6. Aged Receivables > 90 Days	7.5%	< 5%
7. Tangible Net Worth (TNW)		> WC
8. Total Long Term Debt (LTD)		
9. Leverage Ratio (LTD : TNW)		< 3.0
10. Tangible Net Worth / Net Revenues	15.9%	> 8%

(#) Exclude all profit distributions or other excess compensation payments
(*) May want to consider using Net Commissions & Fees

(1) IIABA Best Practices Averages Are Reprinted with Permission of the Independent Insurance Agents and Brokers of America, Inc. All Rights Reserved