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Don't Be Lead Astray

I recently reviewed an article published by one of the nation's leading business appraisal associations. They described a situation that I regularly see negatively impacting agencies:

"Valuations in the world of mergers and acquisitions (M&A) are often very different from reports prepared for other purposes, such as estate and gift tax."

They go on to describe that the definition of value is different, the due diligence process



This is critically important if that report is submitted for tax or legal situations where it

is different, accounting standards are different, and the resulting EBITDA is different.

The huge mistake so many agency owners make, because they do not know the intricacies of business appraisals, is to hire someone who gives them a cheaper M&A valuation that does not meet the criteria required for purposes other than selling their agency.

will almost inevitably be found as not meeting the required standards. This puts the agency owner in a weak position possibly facing significant penalties.

Don't get taken advantage of. Be specific in your requirements. And if you want a trusted person who won't lead you astray, call me.

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Combating Unethical Price Discounts

I have clients coast to coast suffering losses to one or two insurance companies that have found a miraculous way to offer rates 25% less than the overall market. Let's walk through some logical and business-responsible ways in which a 25% lower rate is even possible.

The first place to look is at the historic loss ratios by applicable line of business for these carriers. Were their loss ratios materially better than the industry's, and since their rates were decreased, did their loss ratios increase? Loss ratios should increase materially if rates decrease by 25%, all else being equal.

Historically, one of these carriers has run a pure net loss ratio worse than the industry over the last five years through 2024 (the most recent year available at this detail and date). This is materially worse than the industry in all but one major line of business. The loss ratios have averaged almost eleven percentage points worse than the industry average on an unweighted basis. Even at normal rates then, they are incompetent underwriters.

How can a 25% better rate be justified? It cannot be justified without cutting corners, and I encourage the NAIC and A.M. Best to investigate this.

What corners might be cut? For property, I'd start with TIVs. Are the TIVs correct? A very simple test is to look at the rate filings to determine the full TIVs in a given sample of zip

codes. Divide that by the number and types of properties. Then compare that to third-party sources. It's not a time-consuming test. Using homes for example, if the replacement cost is less than \$200 per square foot, odds are extremely high that the homes are not being insured to value.

Next, look at the forms. Agencies can do this when an insured advises they've found coverage elsewhere. Ask to look at the new carrier's form. But take it a step further and think through the claims practices. I encourage everyone to follow Merlin Law's daily newsletter because they have published some insightful cases involving interesting ways to calculate replacement cost, including suits over the value of totaled vehicles. A carrier can charge less if their forms cover less. And some of these carriers are getting awfully sneaky about how they're calculating replacement cost, including using a different form for adjusting claims versus the form used to determine coverage. It is a bait-and-switch scenario and should be prohibited.

But agents must be excessively careful in discussing these situations because states have insurance specific disparagement laws. These laws state that you cannot offer any opinions about the quality of insurance companies, especially insurance company financial situations, or how they handle claims. All that is allowed is pointing to facts. You can share the A.M. Best rating. You can pull a Yellow Book and point to the numbers, which will likely bore your clients to death.

Or you can collect articles about carriers being sued for bad claim practices. I see a lot of articles regarding a particular carrier's claim practices, and it happens to be the same carrier offering really low rates. That's probably a coincidence.

Agents can also ask their states' DOI for a list of complaints by carrier and share those with clients. Or you can show claims survey data, even data you create yourself. The key is that you offer data only without any commentary. Don't cross the line because these kinds of carriers get a little upset when their practices come to light.

This is a lot of work to address what perhaps the state's DOI should be addressing. But with rates high, regulators will look the other way when a company decreases rates 25%, even if it is not justified. Regulators have more pressing issues.

If it is a direct writer offering significantly lower rates, I would not personally be worried about advising clients of the difference in the standard of care that applies to independent agents versus captives/direct. I wouldn't be concerned because I would not be an order-taker agent. If you are an order-taker agent, you probably don't want to make this point because you're not really any better. But a professional agent can honestly, without really any material increase in risk, explain why independent agents have a greater duty to advise versus all the other categories where the insured must read and understand their policy.

I read an E&O case this morning where the insured had been told they had full replacement cost on their home. Their home burned to the ground in a wildfire. They

learned the replacement cost estimator had severely underestimated the replacement cost and that they did not have the replacement cost endorsement they thought they had. The court ruled they were responsible for reading their policy every year and determining whether they had the right coverage. Insureds have no idea what endorsements are or are not available. That is a ridiculous standard, but it is the standard in that state. A professional insurance agent can point to that ridiculous standard and say, "I'm better. I'll actually read your policies for you. After all, I'm the one with the license."

It is unfortunate that the burden of doing what is right falls squarely on the shoulders of the professional agent and pretty much no one else. To that end, the professional agent deserves to be paid more. I am a big fan of charging fees because standard commissions are inadequate. Every state allows fees, but the regulations vary significantly. Get good legal advice before charging fees, but you are worth the extra money if you are a true professional agent.

And by charging fees, you help distinguish yourself from the arguably unethical insurance entities selling inadequate coverage, using bait-and-switch claims processes, and marginal forms. And you are doing your customers right by taking care of their most valuable assets.

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Trust Accounting

Every once in a while, I write an article on trust accounting. Recently, I was searching my archives and came across one I'd written 20+ years ago. Nothing much has changed, so I feel I'm being redundant writing on this subject again and again.

But many agencies and their CPAs do not know why or how independent insurance agency accounting is different. The problem is exacerbated by agency management systems that cannot handle insurance agency accounting. QuickBooks, for example, is not designed for the specific accounting needs of independent insurance agencies.

What is different about insurance agency accounting requirements?

There are two kinds of billing: direct bill and agency bill. And agency bill is generally the issue. With agency bill business, the agency is responsible for collecting premiums on behalf of carriers. If the insured's premium is \$1,000, the agency must bill and collect \$1,000. That money (less the commission) is owed to the carrier regardless of whether the insured pays, unless a cancellation is processed before the premium is earned.

In the most straightforward example, let's say the agency collects \$1,000 the day prior to the effective date. They deposit \$1,000 and then write a \$900 check to the carrier (the \$100 is their commission).

What happens, though, if the agency pre-bills 30 days early and the insured pays 30 days early? The agency collects \$1,000, which goes into cash. It does not go to income. The offset is a liability often named binder bill or pre-bill. This is because that \$1,000 does not belong to the agency. That \$1,000 still belongs to the insured. It remains the insured's until the effective date. The agency is holding that money in trust, or it is supposed to be.

No income is recorded, regardless of cash or accrual accounting, until the effective date. That prepayment should not be recognized on the income statement until the effective date.

What happens when the insured does not pay their \$1,000 until after the effective date? The agency must pay \$1,000 (maybe \$900) to the carrier to effect coverage. At that point, does the agency have income? Not if it is on a cash basis. On an accrual basis, there will be a \$1,000 premium receivable on the balance sheet offset by a \$100 income addition and a \$900 cash disbursement to the insurance company.

What happens when the invoice is due but not yet earned by the insurance company, but the insured hasn't paid? There should be a premium payable offset by a premium receivable, in whole, not net of commission.

What happens when an insurance company refunds money? The carrier provides a credit to the insurance agency on agency bill business, and the agency typically has 30 days, under most state statutes, to return that premium. That credit is just another form of money held in trust on behalf of the insured or the carrier.

Agency bill is why insurance agencies cannot ever be 100% cash. Maybe on a tax basis they can be, although I'd argue against that. On an operating basis, though, if an agency has agency bill business, it must use accrual accounting, at least partially.

This unique situation is why agencies on a cash basis can incur bad debt, whereas under cash accounting, it is otherwise impossible to have bad debt. This situation occurs when the agency pays the carrier on behalf of the insured, but the insured never pays. Agencies write this off, even when using cash accounting, because the money they lost was largely not their own. They had to make up the loss to the carrier.

Why Does Agency Bill Exist?

Many decades ago, the technology did not exist for insurance companies to collect money directly. Then, once the technology was available, many agencies refused to use it because they wanted to collect money early and invest this "float". This was when interest rates were high.

Agency bill now exists in a much more limited fashion, typically because of accounts in surplus lines where billing is more complicated by the addition of a second middleman. It exists in other situations because some carriers cannot afford a direct bill system. Direct bill is cheaper for retail agencies, and these carriers want to push costs to their agencies.

Trust Laws

Trust laws, which exist in all 50 states and at the federal level, are designed to prevent agencies from spending funds that are not theirs. These laws vary slightly from state to state, but the general rule of thumb is that agencies' cash plus premiums receivable must exceed premiums payable and binder bills. In other words, the numerator divided by the denominator must be greater than 1.0.

This is the trust ratio. Violation of this is usually a statutory problem. It is also usually a carrier contractual problem where the title of the agency's book of business is automatically, without notification, transferred to the carrier(s).

These laws get less sunlight these days because so much business is direct bill. Historically, some agency owners seemed to think the client/carrier monies were theirs, and they spent the money. At some point, their premium payables would be so large, they could not pay their carriers. At other times, someone would turn them into the federal government or state department of insurance. Often they'd go to prison.

What I normally see today is the result of agencies using accounting systems that cannot account correctly for agency bill business. Then, when they prepare to sell their agency or write a check to a carrier, they discover they don't have enough cash. It is quite an unpleasant surprise. This is why understanding agency bill accounting and using systems that properly account for agency bill is critical.

Impact on Agency Value

An agency out of trust does not likely own its expirations, so value is significantly impacted. Some buyers look the other way, deduct from the price, and then add enough cash to bring the trust ratio back to whole. Some walk away. Buyers should want to know exactly why the agency is out of trust before making a decision. If it is fraud, walking is the best strategy. If it is an accident caused by not knowing how to properly account for agency bill business, working out the situation likely makes the most sense.

Why Don't CPAs Know All This?

The majority of CPAs are jacks-of-all-trades. There is no way for them to know all the different accounting rules by industry. Furthermore, most agency owners only ask their CPAs to do their taxes, not offer operational accounting advice.

One reason I'm writing this is so agency owners can take this to their CPAs and request advice on doing their accounting correctly.

Agency bill accounting is a unique creature. Do not treat it the same for accounting purposes as you do direct bill. Furthermore, know your specific agency management system's accounting function because the different systems handle agency bill quite differently. And if you're using QuickBooks, know that it is not designed for agency bill. You will likely need to take some manual steps to account for agency bill business correctly. And remember, agency bill business is always on an accrual basis!

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Chris Burand is president and owner of Burand & Associates, LLC, a management consulting firm that has been specializing in the property/casualty insurance industry since 1992. Burand is recognized as a leading consultant for agency valuations and helping agents increase profits and reduce the cost of sales. His services include: agency valuations/due diligence, producer compensation plans, expert witness services, E&O carrier approved E&O procedure reviews, and agency operation enhancement reviews. He also provides the acclaimed Contingency Contract Analysis® Service and has the largest database and knowledge of contingency contracts in the insurance industry.

Burand has more than 35 years' experience in the insurance industry. He is a featured speaker across the continent at more than 300 conventions and educational programs. He has written for numerous industry publications including the Insurance Journal, American Agent & Broker, and National Underwriter. He also publishes Burand's Insurance Agency Adviser for independent insurance agents.

Burand is a member of NACVA, a department head for the Independent Insurance Agents and Brokers of America's Virtual University, an instructor for Insurance Journal's Academy of Insurance, and a volunteer counselor for the Small Business Administration's SCORE program. Chris Burand is also a Certified Business Appraiser and certified E&O Auditor.

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Burand & Associates, LLC is an advocate of agencies which constructively manage and improve their contingency contracts by learning how to negotiate and use their contingency contracts more effectively. We maintain that agents can achieve considerably better results without ever taking actions that are detrimental or disadvantageous to the insureds. We have never and would not ever recommend an agent or agency implement a policy or otherwise advocate increasing its contingency income ahead of the insureds' interests.

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