The Credit Crisis, Accounting Standards and Insurance Agencies

By Chris Burand

In the midst of the credit crisis and economic turmoil, some very important accounting standards are coming to the forefront. Accounting is almost as boring as IT for most agency principals, but it is worth paying attention because the impact on this industry and your opportunities are significant.

Mark-to-Market

Every large company, including insurance companies and possibly some brokers, are impacted by the mark-to-market rule. This is a very good accounting rule for everyone that believes more transparent financials are good for keeping companies honest. Transparency helps everyone understand whether a company is actually making money or just financially engineering their results.

The press, Wall Street, and politicians keep emphasizing the need to restore trust in our financial system, but they are using trust in a different context. They are hoping people will trust without proof just to get the economy back on its feet and to help the companies that played games and made really bad mistakes survive. But there are many firms that did not make those bad mistakes. Why not let those companies reap the rewards of making the right decisions and playing honestly rather than favoring the failures just because they are huge (or if the firm is so large that failure is not an option, make the terms of the assistance so high that those who made the bad decisions pay the price)?

This entire scenario is so easily evident in the arguments over mark-to-market accounting. The opponents that want it eliminated clearly do understand the issues and/or they want success without working for it. Their argument that this rule is at the heart of our crisis is nonsense because the rule does not even apply to many assets, possibly even a majority of their assets! According to the *Wall Street Journal* (December 1, 2008), credit write downs between the third quarter 2007 and the third quarter 2008 totaled $66.8 billion. Mark-to-market write downs only totaled $30.8 billion, excluding Bank of America and Citigroup which are both special cases.

Mark-to-market is clearly not the problem bankers and CFO's make it out to be. These bankers and CFO's entire thought process seems to be summed up by the statement made by an insurance company CFO, "If we continue to erode shareholder value with liquidation values, there isn't going to be anything left." (MarketWatch.com on 11-21-08) This argument that a steep discount should not be applied to assets that are not currently marketable is illogical. If I buy a house and need to sell it next month but the house cannot be sold for a reasonable price at that time, I have to accept the value for what it is. I'd have to sell at the steep discount.

The mark-to-market rule only applies to assets held for sale, so the rule does not even apply if I can and intend to hold the asset until the market recovers provided the asset is likely to recover its value in time. So if I can wait to sell the house for a year for a reasonable price, the steep discount does not apply. So when you see banks and insurance companies crying about this rule, odds are excellent the company has made some very bad investments they need to sell now, but cannot sell now, and they do not want anyone to know just how bad their situation is. Use this knowledge to place your clients with strong carriers.

Additionally, new impairment rules are set to take effect very soon (in addition to the mark-to-market rule), so you might see some very interesting announcements regarding company write-offs and stability very soon.

Trust Accounts

On the brokerage side, no accounting rules exist stipulating explicit analysis of whether agents and brokers are correctly holding their clients' and carriers' money in trust. This is very unfortunate for all the honest, ethical and properly managed agencies because a good argument exists that if such rules existed, some brokers and agents would cease to exist and others would be much smaller.

For example, the CEO of a large brokerage that recently went bankrupt told me several years ago that a buying firm's balance sheet does not matter to the firm being acquired. He advised that I was doing my clients a disservice advising them to not sell their agencies to him, or anyone else with a bad balance sheet, just because his firm's balance sheet was weak. He was quite explicit in his contempt for my approach even stating that "real" professionals know that EBITDA is all that matters (see my articles on www.burand-associates.com on why EBITDA is a very poor measure).

If an agency is out of trust, they are either out of trust by innocent mistake because they have honest but inept management, poor accounting, or they are following bad accounting advice or because they are unethical. If a broker is out of trust and buying agencies, the implication is clear they are using the money they should be holding in trust, in a fiduciary role, as capital for acquisitions. The fact they intend to repay these funds before anyone notices they are missing is irrelevant. It is still unethical.

Being out of trust means, by definition, spending money that is not yours. If you add your cash and premiums receivable and divide by premiums payable and binder bills and the result is less than 1.0, the agency is out of trust. This means the agency has spent money that is not the agency's to spend and spending money that is not yours is not fiscally responsible, regardless of whether you are in a trust state or not.

For agencies that are out of trust, the soft market and poor economy, especially with large audit returns, will make getting whole more difficult. A number of agencies are already incurring massive problems because they have been out of trust for a long time and always thought they could get away with it, but now the music has stopped and they cannot pay their carriers on time. A broker or two may be having similar issues, but we do not know because accounting rules do not require explicit disclosure of whether the brokers' cash plus accounts receivable exceed their company payables and binder bill (pre-billing).

The fear taxes will climb significantly with Mr. Obama being elected may also mean more agencies will damage their trust position because their accountant may advise them to pull all cash out now without understanding that all the cash is not the agency owners' to pull out. Agency owners must never take money out that is not theirs, even by mistake. Agents must make sure their accountant understands trust account accounting and trust ratios.

The opportunities this situation presents to agents that are in trust are significant. They will be able to hire good employees and attract great clients from the firms that do not manage their balance sheets. Out of trust agencies rarely have the money with which to proactively manage their situations, all they can do is react.

Being out of trust only works in a rising market. It is just another form of leverage, albeit one that is unethical. In a down economy and flat to soft market, many firms practicing this form of leverage will fail. If you are out of trust, get in trust immediately. Borrow money if you have to do so, but get in trust. If you are well-managed, now is a unique opportunity to grow quickly at a fairly cheap price.

Chris Burand is president of Burand & Associates, LLC, an insurance agency consulting firm. Readers may contact Chris at (719) 485-3868 or by e-mail at chris@burand-associates.com.

December 2008