The Balance Sheet Does Matter!
By Chris Burand

The press has filled pages over the last two years with details of the financial misdeeds of large corporations. Several insurance companies have had to modify their financial reports too. A lot of these misdeeds have involved balance sheets. Most people understand the income statement and how revenues must exceed expenses to have a viable and valuable company. However, most people, including some Wall Street analysts, tend to over-look balance sheets. A few big company exec's noticed this loophole and have discovered ways of moving expenses to the balance sheet to improve their earnings reports. If done legally, then it is simply caveat emptor for buyers of those stocks. If not, hopefully, they will be stopped and will have to restate their financial statements.

Even with all the recent press, many agency owners are lulled into thinking balance sheets only matter to these large, publicly held corporations. It would be easy to think this because as long as the agency is in trust, the balance sheet does not usually impact the agency's day-to-day operations (although there are exceptions). Balance sheets do matter though and after twenty years of not paying attention to the balance sheet then, an agency owner with a poor balance sheet might have a rude surprise awaiting him or her when it's time to sell the agency. In an agency sale, provided the buyer is knowledgeable, the balance sheet definitely matters. The degree to which it matters depends on the quality of the balance sheet, the type of acquisition, and the buyer's own resources. But, it always matters.

The most important balance sheet factor is the trust account. Simply put, a knowlegeable buyer is never going to pay full price for an agency that is out of trust. Even if a buyer only purchases the seller's accounts, the seller still has to true up their trust account which effectively acts as a deduction.

Another balance sheet factor is working capital, which is usually closely related to an agency's trust position. A lot of agency owners with inadequate working capital do not understand why their agency value should be docked for having inadequate working capital. Working capital is a firm's investment in its net current assets [(current assets-current liabilities)/(total annual expenses/365)]. Agencies should have at least 30 days working capital.

Adequate working capital reduces risk, thereby increasing value. Adequate working capital acts as a cash shock absorber so agencies can make it through the cash flow bumps life puts in our roads. Eventually, every business will have a month, a quarter, or a year where cash-out exceeds cash-in and without a cushion, the business will go out of business when this occurs (or at least face other unpleasant results) even if vendors, creditors, ex-spouses, and employees know the set back is temporary. Also, in some agencies, the lack of working capital is evidence of significant mismanagement.

Outside of agency value issues, adequate working capital also creates opportunities. For example, when the opportunity to quickly acquire an agency or producer presents itself, agencies with adequate cash usually have an advantage in these situations.

Leases are often a contentious topic in agency valuations. The problem arises from accounting rules which do not require that leases be shown as liabilities on balance sheets even though they are liabilities. Therefore, just because they are not shown on the balance sheet, many accountants and some agency owners do not think they should be counted as a liability for valuation purposes. However, as the saying goes, "A rose is a rose by any other name." In fact, some companies structure liabilities as leases so that the liabilities are not shown on the balance sheet which suggests that for valuation purposes, a deduction should be made to accurately reflect the agency's liabilities. If the lease is too onerous and not breakable, leases can indeed significantly decrease an agency's value. If you are thinking about selling, consider this before signing your next lease.

Goodwill often results in a big balance sheet deduction too because any goodwill value that exists from past acquisitions will be considered in the value of the selling agency's book of business. To not eliminate it would result in double counting. This is an unpleasant reality for some owners that have purchased several agencies and are now selling their own.

Loans to the agency from an agency owner(s) are often deducted too because it is often clear the loan will never be repaid. Therefore, it cannot be considered a loan for valuation purposes.

Accounts receivable may be modified if an agency has a long history of bad debt OR the agency has lots of old receivables on their books. The chances that all those old receivables will be collected are nil and therefore, the agency value will be reduced.

Although there are many other potential issues, these are the major balance sheet factors and these factors make a significant difference in an agency's value. Take forty-five minutes to consider these factors and your agency's balance sheet. Does the balance increase your agency's value or decrease it? If it's the latter, the best time to start fixing it is right now.

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.

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