

How Much to Charge Your Brother-In-Law? ***by Chris Burand***

Imagine, for a moment, you are the owner of a company that builds fancy lawn chairs and your pesky brother-in-law wants a set of lawn chairs at cost. You agree to sell them at cost, but how much does it actually cost build a lawn chair? Below are your company's expenses:

<u>Item</u>	<u>Cost per chair</u>	<u>Running Total</u>
Materials	\$60	\$60
Direct Labor	\$30	\$90
Operating Expenses (Rent, benefits, staff, insurance...)	\$20	\$110
Transportation	\$3	\$113
Sales Commission	\$5	\$118
Average profit	\$5	\$123

Which of these expenses should you include to determine your brother-in-law's price? Most people would agree that materials and direct labor should be included and most would agree that since your brother-in-law is going to pick up the chairs himself, no transportation expense would be included nor would sales commission. Also, most people agree that "at cost" implies no profit. Operating expenses, like rent and benefits, is the only category then that is not clear cut. Should you charge your brother-in-law for these expenses?

To build the lawn chair, the factory has to have insurance. Electricity is required as is factory space and staff to manage the computers, answer the phones and keep the books. Benefits are required to get and keep quality employees. It cost money to buy tools. These expenses are all required so they should be included, right?

Your wife, who is accusing you of being a cheapskate, believes you would have to spend this money regardless of whether her brother buys a lawn chair or not, and therefore these costs are not directly attributed to his particular chairs. According to your wife then, the at cost amount should be \$90. Setting aside the fact that you don't really like your brother-in-law, you feel strongly the price should be \$110. But, how do you convince your wife?

Since you and your wife are discussing this over dinner at a trendy restaurant, you cite a recent *Wall Street Journal* article showing that restaurants often charge \$5-\$10 for a salad that costs them less than a \$1. They charge \$22 for salmon that costs them \$2.50. In fact, just to breakeven, they average a markup of 300% over their food costs. If they only averaged a 200% markup, they would likely go out of business. In other words, all those little things, like rent and insurance, really add up. Just because those costs cannot easily be attributed to one specific meal or one specific lawn chair, does not mean those costs should be ignored.

Your wife is peering at you dubiously over her wine glass as you cite yet another *Wall Street Journal* article, so you decide you need another example closer to home. She works for a regional telephone company so you ask why phone calls should not be free. It does not cost the

phone company anything extra for a person to make a call. The lines, exchanges, and computers are already there. "Yes," she says, "but we all have to pay collectively for the lines, the maintenance, and staff to keep the system running." Bingo! Every customer also has to pay for all those behind-the-scene costs that enable us to build lawn chairs!

What do lawn chairs have to do with insurance sales? Not much, except operating expenses. Agencies too must consider operating expenses when making sales. Many agency owners would exclude operating expenses when selling to their brother-in-law. In fact, most exclude these expenses when selling to strangers.

How can agencies exclude operating expenses when they do not even set prices? Agencies do not ignore operational costs by setting prices too low (though by negotiation with companies for lower rates they do contribute to low prices). Agencies ignore operational costs when they determine producer compensation. An agency's commission usually covers (though not always, according to our studies) producer and CSR compensation, advertising, and other selling expenses. The price, however, does not usually cover those expenses plus all operating expenses. As a result, the Academy of Producer Insurance Studies (APIS) found that the average agency spends \$1.02-\$1.04 for every \$1.00 of commissions earned (*Growth and Performance Standards*, APIS, 2000).

Selling one more policy at less than full cost does not make much difference but most insurance agencies sell too many producer serviced policies at less than full cost. Selling in this manner is like an alcoholic's life philosophy. The first drink did not do any damage so let's do twelve more. Sell enough insurance at below cost and you end up in the hole, spending \$1.03 for every \$1 of commission.

To stop the bleeding, ask yourself, "How much can I afford to spend to make a sale?" Again, on any individual sale, operating expenses do not make much difference. But on a producer's book, which obviously requires rent, computers, electricity, non-CSR staff, and so forth, these expenses make a huge difference. For example, the scenario below is quite common:

Producer's book	\$170,000 commission
Producer's cut \$68,000	(40% of the agency's commission)
CSR	\$30,000 (the average agency has one CSR for every producer)
Benefits	\$9,800 (10% of producer's and CSR's compensation, including employment taxes)
Sales Costs	\$27,200 (16% of commissions, national average for medium sized agencies*)
Operating Expenses	\$61,200 (36% of commissions, national average for medium sized agencies*)
TOTAL	\$196,200
Profit/Loss	-\$26,200

**Growth and Performance Standards*, APIS, 2000

Earn \$170,000. Spend \$196,200. And this does not even include management or owner

compensation, staff other than the CSR, benefits for anyone other than the producer and CSR, profit sharing, or profit!

The average agency spends at least 10% (including a lowly 7% profit margin) more than they charge their commercial clients. Can agencies increase prices 10%? Most salespeople would say they can not and still keep the business. The only other alternative then is to cut expenses and/or increase productivity, both primarily through producers because the average producer does not produce enough business for what they are paid. Because many operational expenses do not increase with book size, it is critical agencies motivate producers to get past their book's breakeven point and get rid of producers that fail. For most agencies at current producer compensation levels, a general rule-of-thumb is producers must generate \$200,000-\$250,000 in commissions to breakeven. (*Please note: each agency must determine their own breakeven point because it varies considerable from agency to agency and it even varies between different departments within the same agency.*) Another alternative is to use a more innovative compensation system that pays only for profitable business rather than any and all business. For example, pay bonuses/assess penalties for high/low hit ratios and high/low retention rates, pay nothing for small accounts (you define "small"), and pay less for small books.

Start your agency on its way to making money on its sales, rather than losing money. Take a detailed look at ALL the costs of making a sale. Do not let your brother-in-law or your producers leave you holding the bill for your operating expenses!

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