

# Total Insurance Inc.:

## Application Of ABC Management Concepts For Evaluation Of Sales Teams

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### ABSTRACT

*Total Insurance, Inc. (TII) is an instructional case to expand students' understanding of potential benefits of ABC beyond traditional manufacturing applications rather than as a technical ABC application exercise. It does not require complex calculations, yet it allows instructors to discuss why companies may adopt some ABC concepts and demonstrates the process by which they create and develop the information to build the system. Jack White was the CEO of TII, a successful independent insurer. Several major insurance providers, such as Travelers, Erie, and The Hartford, rely on independent agents around the nation to sell and service their policies. The company acted like a broker between the insurance providers and the customers, but it is truly an agent of the insurance provider in each transaction. The company handled \$100 million in premium volume, mostly from commercial insurance (\$86 million) with very different apparent performances from their sales force teams. The teams of one or two sales producers had one to five other employees and drew differently from the common resources of the firm. He was having trouble distinguishing which of his sales teams were contributing most to his bottom line. He particularly needed this information in order to help the sales teams to improve their own productivity. White, recalling an accounting course he had taken in his Executive MBA program, decided to investigate the ability of ABC analysis, as applied in that course toward evaluating customers, to gather data on cost drivers and resource use to determine the productivity of his sales teams.*

**Keywords:** ABC Management, Insurance Industry, Performance Evaluation of Sales Teams

### INTRODUCTION

Jack White found himself explaining to a friend at a cocktail party what he thought were the key elements of his success as the CEO of one of the most prosperous independent insurance agencies in the mid-Atlantic region of the U.S. He cited the teamwork atmosphere that the company had developed, and expressed the feeling that he had chosen excellent people to join him at Total Insurance, Inc. (TII). However, he admitted that he had trouble distinguishing which of his sales teams were contributing most to his bottom line. Like many agencies that he knew, he had developed teams within the agency to which he provided leadership and common services. TII's teams of one or two sales producers had one to five other employees and drew differently from the common resources of the firm. His conversation ended with White wondering if he could effectively answer the question of which of his teams were the most productive in terms of net profit to the organization.

He recalled managerial accounting courses he had taken and cases he had studied in his Executive MBA studies at Loyola University Maryland. He remembered how Activity Based Costing (ABC) was cited as particularly effective at identifying the costs and cost drivers that impact profitability and wondered if he could put the concept, methodologies and data together to get a better picture of the profitability of his sales teams.

## THE INSURANCE INDUSTRY

Many insurance companies rely on a nationwide network of independent agencies and brokers to sell their products. Unlike the captive agents who are employees of an insurance company or telephone sales representatives, independent insurance agents and brokers are separate entities and represent an average of eight different insurance companies. (See Exhibit 1 for an overview of the commercial insurance distribution system.) This allows them to research these firms to find their clients the best combination of price, coverage, and service. The law is not clear as to whether the independent insurance agent has a fiduciary responsibility to act in the customer's interest. In fact, the word "agency" itself would indicate that the independent agent's primary attachment is to the carrier (<http://www.disasterprepared.net/fiduciary.html> - Accessed 6/30/09). Exhibit 1 shows the distinctions among the general types of insurance providers.

**Exhibit 1: Commercial Insurance Distribution System**

Type of Service	Customer Contact	Products	Carrier Examples
Direct from carrier	Carrier office or HQ or by phone or Internet	Any coverage that carrier provides	GEICO Progressive
Captive agency	Local agency under franchise agreement	Any coverage that carrier provides	State Farm Allstate
Independent agency or broker	Local agency	Any coverage by any carrier	The Hartford Travelers

The insurance companies (also known as carriers or underwriters) are the product providers who issue policies and assume risk in exchange for premiums. The insurance industry is a global business. Worldwide premiums exceeded \$3 trillion in 2006. In the United States, which accounts for about 34 percent of the world's insurance business, premiums are more than \$1 trillion per year. The U.S. insurance industry employs more than two million workers, about 2.1 percent of the nation's workforce (<http://www.bls.gov/oco/cg/cgs028.htm#employ> – accessed 6/29/09).

In the U.S., the insurance business is generally viewed as three distinct segments; property/casualty, life, and health. The property/casualty segment of the industry provides insurance for cars, homes, and businesses. Property/casualty insurance can be broken down into two major categories: commercial lines of insurance and personal lines. Personal lines, as the term suggests, include coverage for individuals, such as automobile and homeowners insurance. Commercial lines, which account for more than half of U.S. property/casualty insurance premiums, include many kinds of insurance designed to protect businesses. Commercial insurance performs a critical role in the world economy. Commercial insurers assume the risks inherent in the production and distribution of goods and services. This transfer of risk protects insured companies from catastrophic losses and potential financial ruin that could result from an accident, mistake, or natural disaster. The ability of commercial insurers to guarantee the stability of the U.S. and world corporations was challenged in the monetary crisis and serious recession of 2008-2009.

## FINANCIAL REPORTING

Insurers in all states are required to use a special accounting system when filing annual financial reports with state regulators. This system is comprised of and named for its statutory accounting principles (SAP). SAP accounting is more conservative than generally accepted accounting principles (GAAP), as defined by the Financial Accounting Standards Board, and is designed to help ensure that insurers have sufficient capital and surplus to cover all anticipated insurance-related obligations (<http://www.investopedia.com/terms/s/sap.asp> - accessed 6/29/09). The two systems differ principally in matters of timing of expenses, tax accounting, the treatment of capital gains, and accounting for surplus. Simply put, SAP recognizes liabilities earlier or at a higher value, while also recognizing assets later or at a lower value. GAAP accounting focuses on a business as a going concern, while SAP accounting treats insurers as if they were about to be liquidated. SAP accounting is defined by state law according to uniform codes established by the National Association of Insurance Commissioners. Insurance companies reporting to the Securities and Exchange Commission must also maintain and report a financial reports that meet GAAP standards.

**TOTAL INSURANCE, INC**

Total Insurance, Inc. (TII) was established in 1969 by Jack White. White immigrated to the United States in 1951 as an orphan. Following a stint in the United States Army, he found a job as a personal automobile policy underwriter. He later became the business manager and leading salesperson of another insurance agency before leaving to start TII. From modest beginnings, TII has become the 3<sup>rd</sup> largest privately owned commercial insurance agency in the Baltimore region (growing from \$300,000 to more than \$100 million in annual premium volume). With a staff of more than 90 insurance professionals, TII serves the Mid-Atlantic region and offers a full complement of insurance products: commercial property and casualty; homeowners, car and boat; surety bonds; professional liability; term, universal and whole life; and health insurance. Exhibit 2 provides some key financial measures between the TII and the industry.

**Exhibit 2: TII Performance In comparison with the Industry Benchmarks**

Measurements	Average	Top 25%	TII
Current Ratio	1.24	1.78	1.59
Tangible Net Worth	4.20%	25.10%	30.57%
Receivable/Payable Ratio	48.70%	10.50%	27.52%
Revenue Per Employee	\$160,361.00	\$180,355.00	<b>\$113,224.57</b>
Compensation Per Employee	\$105,938.00	\$103,856.00	<b>\$ 51,216.61*</b>
Employee Marginal Profitability	\$ 54,423.00	\$ 76,499.00	<b>\$ 62,007.96</b>
IT Expense as a % of Revenue	1.80%	1.80%	2.67%
Non-Payroll Expenses as a % of Revenue	31.13%	29.10%	<b>37.02%</b>
Support Personnel as a % of Total Revenue	18.28%	17.40%	17.34%

\*TII's sales people were equity holders in the company and were otherwise compensated on a commission-only basis, which is not typical in the industry.

The company is organized into three operating departments—commercial insurance, personal insurance and employee benefits. The commercial insurance department, which constitutes 90 percent of TII's revenues, is divided into 18 sales teams that support 24 independent sales agents (or producers). Forty-two (42) direct support staff members are assigned to the sales teams and have generally been allocated purely on the basis of premium volume. In addition, there are 15 indirect support staff providing administrative, secretarial, billing, information technology and service functions to all sales teams.

**THE TII PROBLEM**

Although TII is one of Maryland's most successful privately held insurance agencies, it has managed to operate for the past 38 years without any formal cost accounting system. There are many common business decisions that have been difficult to address due to the lack of a cost allocation system. These issues include:

- Measuring the profitability of sales teams
- Allocating agency financial and human resources to sales teams
- Predicting and planning for future resource requirements
- Evaluating the profitability of key customers or customer segments

Jack White decided to apply Activity Based Costing (ABC) to address these issues. He was most concerned about his commercial insurance department which represented ninety percent of his agency's revenue, so he began the process of identifying what would be necessary for an ABC analysis of this part of the business.

White recognized that, typically, activity based costing (ABC) first assigns costs to the activities that are the real cause of the overhead. It then assigns the cost of those activities only to the cost objects that are actually demanding/using the activities. In his case he considered the sales team to be the cost object and he would like to

apply the same principles to allocate his overall expenses to the sales teams. He recognized that this is not a typical ABC used in manufacturing firms, where the company categorizes its activities into Unit level, batch level, product level and capacity sustaining level. He thought that the cases where service companies used ABC for measuring customer profitability were closer to meeting his needs.

White decided that he needed to implement his plan by taking the following systematic steps.

1. Gather annual data by sales person and by team.
  - a. Sales
  - b. Income
  - c. Activities (e.g. transactions)
2. Analyze annual company expense data and determine whether expenses are fixed or variable
  - a. Fixed Expenses - determine an equitable allocation method
  - b. Variable Expenses - evaluate possible cost drivers to see which of them best predict and measure expense development
3. Develop most important cost drivers for cost allocation
  - a. Determine the most rational and predictive cost driver for each expense
  - b. Assign cost drivers to individual expense categories
  - c. Calculate a per unit cost for each expense category
4. Establish a financial statement that allocates costs and profits by sales team
  - a. Input sales data from Step 1
  - b. Calculate expense items by sales teams using the drivers calculated in Step 3c
5. Assess the reasonableness of the results and reassess if necessary

White was able to secure sales, income and activity data directly from the management accounting system of TII. He selected six of the teams to reduce the total analytical work load and categorized the data by sales team. Exhibit 3 summarizes some of the costs and revenues attributable to six of his teams.

**Exhibit 3: Summary Data on Costs and Revenues Associated With Six Representative TII Teams**

	<b>AMcD</b>	<b>BH</b>	<b>LAS</b>	<b>DiP</b>	<b>WC</b>	<b>MDD</b>
Premium Volume	\$8,797,507	\$5,012,435	\$1,050,329	\$10,031,291	\$6,396,396	\$8,420,663
# of Producers*	2.0	1.0	1.0	2.0	1.5	1.0
# of Transactions	2071.0	1263.0	587.0	2866.0	1799.0	919.0
# of Employees*	5.00	3.00	1.80	3.85	4.50	1.00
Gross Commission Income	\$921,602	\$418,539	\$198,459	\$958,592	\$711,471	\$696,267
Less: Commission's Paid	-\$414,721	-\$188,343	-\$89,307	-\$431,366	-\$320,162	-\$313,320
Agency Revenue	\$506,881	\$230,196	\$109,152	\$527,226	\$391,309	\$382,947
Unit Payroll	\$233,360	\$162,800	\$57,905	\$187,148	\$234,292	\$50,980
Shared Payroll	\$77,314	\$47,150	\$21,914	\$106,993	\$67,160	\$34,308
Total Payroll	\$310,674	\$209,950	\$79,819	\$294,141	\$301,452	\$85,288
Departmental Margin	\$196,207	\$20,246	\$29,334	\$233,085	\$89,857	\$297,659
Sales margin %	38.71%	8.80%	26.87%	44.21%	22.96%	77.73%

\* Fractional people indicate shared resources or part-time employees.

From the accounting system of TII, he was able to produce an annual summary of expenses. These expenses were grouped by category. All expenses were common to a sales and service organization. Throughout the process, he attempted to use logic that was consistent with his accounting lessons. He started by evaluating TII's expenses to determine if they were fixed or variable costs, which were used in making his decisions about the most rational way to allocate these costs.

## COST DRIVERS

This was one of the most important elements of the project. He evaluated numerous potential drivers that were relevant to the insurance industry. He endeavored to determine which of these potential drivers would help him allocate costs in the most rational and predictive manner. Ultimately there were only a handful of logical cost drivers (listed in the Exhibit 4). He used this list to select a cost driver for each expense category and then calculated the per-unit cost for each expense.

**Exhibit 4: TII Cost Drivers**

TII Cost Drivers	
Number of Producers	24
Number of Employees	42.15
Premium Volume (in \$1,000)	\$85,875.40
Number of Transactions	21,720

*Note: See [Appendix 1](#) for a listing of the expense categories and appropriate cost drivers and [Appendix 2](#) for the per unit costs values for each expense category.*

## DEVELOPMENT OF COST DRIVERS

1. Number of Producers (Sales People): He used the number of sales people to classify certain expenses. For example, advertising expenses benefit each producer equally in their ability to win customers, therefore it was determined that advertising costs were variable based on the number of producers, even though an additional producer wouldn't increase advertising costs.
2. Number of Employees: The number of direct support employees proved to be a good measure of other expense types. For example, rent expense was best measured by the number of people assigned to each sales unit—as the number of people changes, space requirements change proportionally.
3. Premium Volume (Total Sales Dollars): Premium volume was used to measure expenses that vary in proportion to sales, for example, company insurance for “errors and omissions” is based largely on sales volume.
4. Number of Transactions (Policies Serviced): The number of transactions was an accurate cost driver for expenses linked to the processing of policies, such as courier fees, office supplies and telephone expense.

The purpose of Activity-Based Costing is to provide management a clear picture of the cost structure of their organization. There are numerous strategic decisions that will be impacted by the results of this project. With an accurate picture of the costs and the activities that drive cost, management can then develop a plan to control costs and reduce or eliminate redundancy from the system.

Underperforming sales teams will be challenged to increase output or face cost constraints. Sales people who focus on unproductive clients will be challenged and trained to pursue more profitable sales activities. Future resource allocation decisions will be aided by an accurate picture of existing resource commitments. This will help to ensure that resources are dedicated to productive, profitable areas.

As White began to see how his system might work, he designed a memorandum (Exhibit 5) to send to his sales teams when he had a good sense of whether his system would help form performance criteria that would help TII to assist the sales teams in making choices that will increase the profitability of the company.

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**Exhibit 5: Jack White's Draft Memorandum to Team Leaders**

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To: The Executive Team  
From: Jack White  
CC: [Recipient names deleted - privacy]  
Date: TBD  
Re: Performance Management

Comments: The purpose of this memorandum is to outline some thoughts around the difficulty we have been experiencing with the issue of performance management among our sales teams. We have struggled to find an effective manner to judge each team, and every time we try to implement a measurement system we seem to come up against opposition; and often these criticisms are warranted.

It would be nice to set expectations in very simple terms; however, every time we try that, we run up against the same issues and complaints. Sales teams complain that their circumstances are different than others and they have more work than the other teams. "In order for me to grow, I need more help." Add to that the fact that our structure also makes it difficult to impose a standard of performance. Sales people who own their books of business are reluctant to accept external pressure for additional sales activity. On the other hand, good business requires the correct allocation of resources, and growth efforts require capacity. Because our sales people own their clients and get paid strictly on a commission basis, you might think that there is every incentive in the world to constantly be growing. And maybe there is; however, even the desire to grow is impacted by the capacity to do the work necessary to grow. I see it as essential to develop a financial model that gives us an accurate picture of what is really going on so we can discern the real barriers to growth, identify capacity and subsequently expectations that tie into our growth objectives. Simplistic evaluations have left us wanting for a methodology that truly measures our situations.

We always know the top and the bottom performers. The top rarely need much in the way of encouragement or objectives. Rather they clamor for accountability among the lower performers. At the other end, the bottom performers are typically easy to see and their issues are commonly due to capability rather than the lack of specific objectives. It is the middle performers that perplex me. If we can develop a performance standard for this group that provides accurate insight, then we can make decisions on how to allocate resources to their improvement. Tools like training, mentoring and support can be applied appropriately. This situation can't be a completely unique. I sometimes wonder if the evaluation of sales performance in our organization is similar to the challenge faced by a multi-location retail organization. For example, what to do when you have two stores generating similar sales levels in similar geographic territories.

The real challenge is to make sense of the complexity in comparing two books of business. When I look at the data that we generate when we allocate expenses based on revenue I intuitively know that some of the results are skewed. When I take two salespeople with nearly identical revenue yet a completely different number of clients served, the complexity begins. Add to this the ability to transfer some work to our insurance carrier partners and the impact on our activity, the complexity is expanding. Other factors include marketing/re-pricing activity, billing activity/accuracy, certificate of insurance (verification of coverage) to name a few. Our salespeople love to point out the unique demands of their book of business when we discuss their growth challenges. I am reminded of a management paradox – attribution error. When I cut into traffic it is because I am running late for a very important meeting. When I get cut off, it is because of the character flaws of the other driver. We believe our behavior is driven by circumstance and the behavior of others is driven by their character. Proper sales management eliminates this paradox.

Based on the knowledge I gained in the Executive MBA program and, especially, in Managerial Accounting, I believe we may be able to apply a cost analysis tool to build the requisite bridge. Proper cost allocation will allow us to create a method to break through the complexity of evaluating a book of business to see what impact different activities have on our ability to create bandwidth to grow. Once we have a clear picture of our reality, then we can establish benchmarks for performance and create incentives for our sales teams to grow. This will enable us to align their desire for support with our need to increase our number of customers and revenue. It should also help us better define ideal clients.

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## QUESTIONS

1. How does TII compare with other companies in its industry?
2. Organizations are always looking for ways to improve their profitability, but what do you think prompted TII use ABC to evaluate team performance?
3. What additional steps should have been considered to confirm/ justify the selection of the cost drivers listed in Appendix 1
4. Apply ABC to measure the profitability of the sales teams by using the selected expenses and cost drivers from Appendix 1.

## AUTHOR INFORMATION

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**Thomas E. Carroll** is the President of Diversified Insurance Industries, Inc. since 2004. He earned a BS from Towson University in Accounting and Finance and an Executive MBA from Loyola University Maryland and is a graduate of the Entrepreneur Development Center at the University of Maryland University College. He participates on many insurance advisory boards and is active in the local community.

## APPENDIX 1

## Expense Categories and Relevant Cost Drivers

Expense	Absolute Expense	Direct/Indirect	Cost Driver
Advertising	\$5,500.00	Indirect	# of Producers
Amortization	\$20,200.00	Indirect	Premium Volume
Automobile Expense	\$35,000.00	Direct	Traceable
Computer Maintenance	\$75,000.00	Indirect	# of Employees
Depreciation	\$32,500.00	Indirect	# of Employees
Donations	\$12,000.00	Indirect	# of Producers
Education	\$35,000.00	Indirect	# of Employees
Entertainment	\$25,000.00	Indirect	# of Producers
Equipment Maintenance	\$13,000.00	Indirect	# of Employees
Accounting Fees	\$101,500.00	Indirect	# of Transactions
Legal Fees	\$13,000.00	Indirect	Premium Volume
Other Professional Fees	\$25,000.00	Indirect	Premium Volume
Insurance	\$150,000.00	Indirect	Premium Volume
Medical Insurance	\$175,600.00	Indirect*	# of Employees
401K Expense	\$23,086.50	Indirect*	# of Employees
Office Supplies	\$88,150.00	Indirect*	# of Transactions
Life Insurance	\$15,000.00	Direct	Traceable
Payroll Taxes	\$425,000.00	Indirect*	Total Payroll
Postage	\$35,000.00	Indirect	# of Transactions
Courier	\$13,023.00	Indirect	# of Transactions
Rent	\$325,000.00	Indirect	# of Employees
Temp Salaries	\$2,500.00	Indirect	Traceable
Taxes & Licenses	\$25,000.00	Indirect	Premium Volume
Telephone	\$50,000.00	Indirect	# of Transactions
Travel	\$10,000.00	Indirect	# of Producers
Bad Debts	\$1,000.00	Indirect	Allocate/ Traceable
Unit Payroll	\$2,115,246.00	Direct	Allocate/ Traceable
Shared Payroll	\$810,847.00	Indirect	# of Transactions
Total	\$4,657,152.50		
Non-Payroll expenses	\$1,731,059.50		

\*These indirect costs are directly associated with payroll, composed of Unit Payroll and Shared Payroll.



**APPENDIX 2****Per Unit Cost by Expense Category**

<b>Expense</b>	<b>Cost Per Driver Unit</b>
Advertising	\$229.17
Amortization	\$0.2352
Automobile Expense	
Computer Maintenance	\$1,779.36
Depreciation	\$771.06
Donations	\$500.00
Education	\$830.37
Entertainment	\$1,041.67
Equipment Maintenance	\$308.42
Accounting Fees	\$4.6731
Legal Fees	\$0.1514
Other Professional Fees	\$0.2911
Insurance	\$1.7467
Medical Insurance	\$4,166.07
401K Expense	\$547.72
Office Supplies	\$4.0585
Life Insurance	
Payroll Taxes	\$10,083.04
Postage	\$1.6114
Courier	\$0.5996
Rent	\$7,710.56
Temp Salaries	
Taxes & Licenses	\$0.2911
Telephone	\$2.3020
Travel	\$416.67
Bad Debts	
Unit Payroll	
Shared Payroll	\$37.3318

**NOTES**