Assessing Your Financial Risk

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What a time to be a PEO. The economy and stock market are performing well and the industry is continuing to grow year after year. I think we can all agree that growth is good. Like all good things, however, growth brings challenges. The numbers get bigger. The clients get bigger. The risk gets bigger. As the risks get bigger, we must do more and more to manage them. Managing financial risk is one of the most important responsibilities of any company, and arguably the most important thing for a PEO. In today's world, companies of all sizes are looking to develop robust financial risk management frameworks that adhere to compliance demands, contribute to better decision-making, and enhance performance. Two areas of interest seem to be loss-sensitive insurance programs and financial reporting and cash flow management.

Loss-Sensitive Insurance

PEOs often participate in loss-sensitive insurance programs for workers' compensation and medical benefits. In this scenario, the PEO shares some of the carrier risk under what is often called a high-deductible program. These deductibles vary based on the carrier and the PEO's appetite for risk. These programs can help boost profitability and defer cash expenditures if managed properly. However, proper internal controls must be adopted to reduce financial risk in the future.

When working with loss-sensitive workers' compensation, it is important to understand the varying impact claims can have on financial statements. The cost of claims cannot be determined up front; premiums are estimated and are accompanied by loss development factors, which can increase the cost of a claim substantially over time. In addition to this, it is not uncommon for closed claims to be reopened in the future. To help value this developmental risk, carriers often provide a loss development factor (LDF) that is applied to current loss runs to determine an ultimate value or exposure. The LDF is calculated primarily by the state in which premiums are earned. For example, California is known to carry a much higher rate due to its litigation clauses and probability for claims to reopen in the future. It is prudent to reference the carrier policy agreement, as loss development factors are often contractually predetermined and will dictate future funding requirements.

When managing financial risk, proper internal controls must be adopted to monitor the development of monthly losses so they can be properly recorded on financial statements. The carrier will often require the insured to fund the loss reserves annually. It is highly recommended to hire an actuary familiar with loss-sensitive workers' compensation programs to periodically review the performance of loss runs and ensure the carrier LDFs are consistent with the actual development of the claims. The PEO can often rely on both sets of data when reviewing financial performance and funding requirements.

In all loss-sensitive programs, it is important to use tools to sufficiently price your clients and prospective clients. When pricing a group with a higher experience mod, you may consider getting the client to share in some of the risk. This would include implementing a safety-incentive program through which the client could receive a financial incentive for good performance, or putting in place a model in which the client would be given a predetermined deductible per claim.

Employing claims adjusters and nurses to help administer open claims and develop an effective back-to-work program are other methods used to mitigate claim risk and development exposure. Closing claims expeditiously can significantly reduce the PEO's claim exposure, thus reducing financial liability. Not only is establishing these tools important, but periodically reviewing their performance is key. When a premium dollar is received from a client, several slices of that represent revenue that has to be used to pay the carrier and agent and build reserves for future claims, and only a sliver of that is operating profits. Understanding the fixed and variable cost components of these types of policies is an art. It also involves a little bit of luck.

Financial Reporting and Cash Flow Management

We cannot stress enough the importance of proper financial reporting. No matter the size of your PEO or how you are structured, strong financial reporting provides a strong foundation for the business. The foundation of strong financial reporting is a strong accounting team. Developing and maintaining a strong accounting team requires much more than simply hiring a bookkeeper. Core responsibilities of the accounting team include:

- Frequent reconciliation of payroll taxes;
- Proper allocation of cash receipts;
- Identifying and tracking liabilities as incurred;
- Daily cash reconciliations;
- Quarterly state unemployment and withholding compliance;
- Frequent meetings to review cash balances and needs;
- Rolling budgeting and forecasting;
- Monthly financial reporting; and
- Tracking insurance premium and collateral requirements.

The objective of each of these practices is to ensure that the company is on top of its financial obligations and unlikely to be blindsided by unforeseen liabilities. Careful management of near-term liquidity needs further enables managers to allocate resources to growth initiatives without compromising the company's ability to meet existing business obligations. This is financial risk management.

It's hard to get where you're going without a map. In the same sense, financial forecasting can be an indispensable tool in successfully executing an ambitious multi-year growth strategy. A good cash flow forecast can be as simple as a summary profit and loss (P&L) with a few additional inputs, or as thorough as a dynamic three-statement financial model with detailed inputs and assumptions. Income is not a proxy for cash flow. Regardless of the level of complexity, a cash flow forecast should include:

- Revenue. The starting point of most forecasts is revenue. Future revenues can be forecasted using a top-down approach such as applying a growth rate percentage to the prior years' revenue amount, or using a bottom-up approach based on growth within existing customers and new business based on the size of the sales team/opportunity pipeline and historical closing rates.

- Gross profit margin. Have gross margins been stable in the past, or have they exhibited a trend that is expected to continue? Is projected growth due to entering a new industry vertical, specialty, or pursuing a different type of customer? If so, how do changes in the customer makeup and/or service mix translate into changes in gross margin? These are the types of questions that should inform estimates of future gross margin levels.
- Capital investments. The cost of capital investments is recognized on the income statement over a period of years via depreciation. While the accounting impact of these investments is spread over their useful life, the cash cost must be paid immediately. New computer systems, office expansions and other leasehold improvements, and similar items should be part of a capital expense plan and deducted from cash flow in the financial forecast.
- Debt and interest payments. If the company uses debt financing, mandatory principal and interest payments will consume cash flow and should be included in the forecast. If the company is required to comply with financial covenants, the forecast should calculate the relevant covenants on a *pro forma* basis to ensure the company remains in compliance.
- Dividends. Anticipated dividends and shareholder distributions (for tax payments or otherwise) must be included to get an accurate picture of total cash flow.
- Loss-sensitive insurance funding. Cash forecasting is particularly important when a PEO participates in a loss-sensitive insurance program, as a simple P&L statement does not represent actual cash activity. This is driven by the need to collateralize loss funds and reserve for future losses.

Another important aspect of managing financial risk is the balance sheet. A properly reconciled balance sheet should reflect the current liquidity position with respect to satisfying short-term liabilities such as tax and insurance payments previously collected from clients. In understanding the working capital position of the PEO, one will be better positioned to accurately distribute profits and plan for future income tax liabilities. Proper balance sheet management will allow you to maintain compliance with state licensing laws, as many states require all PEOs to maintain certain levels of working capital and/or net worth.

Financial risk management all comes down to discipline. A financial issue will be much less surprising and can often be avoidable with careful forecasting and strong financial risk management. ●

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