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the Reduction and Control
of Acquisition and Other Expenses



Scovell, Wellington & Company
Accountants—Engineers

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BOSTON

Budgetary Control for Insurance Companies

It Points the Way to the Reduction and Control of Acquisition and Other Expenses

THE problems of acquisition and other insurance costs, according to the June, 1930, hearing at Chicago before the Committee on Acquisition Costs of the National Convention of Insurance Commissioners, are becoming more involved and more important to all concerned.

In its report on a survey of fire acquisition costs, the Commissioners' committee has made this statement: "It is needless to say that the acquisition costs and other expenses of fire insurance companies have increased during the past ten years. In view, however, of the manner in which reports are made, it is impossible to determine the principal source of increased expenses."

This lack of complete information as to costs, noticeable with life and casualty companies as well as fire companies, is characteristic not only of the reports submitted to insurance commissioners, but also of the internal administrative reports of the various companies. The company which has a managerial expense analysis scientifically prepared is a rare exception. Most company expense statements follow the general requirements of the convention statement, schedules and exhibits—generally with more details but yet not sufficiently detailed to enable the companies to indicate specifically where increased costs occur.

Insurance companies are under constant pressure to reduce their operating expenses. The costs of doing business are under scrutiny by owners, executives, bureaus, government authorities, policy holders, agents and brokers. For example, to reduce acquisition costs efforts are often directed toward cutting down agents' and brokers' commissions. The agents and brokers naturally resist this move, and suggest that the companies first apply their efforts internally.

The average company makes drastic cuts in expense after the close of a year. Many times the reductions are not in line with the needs of the business, and the expense is added on again gradually and no saving results. Feeble attempts have been made to correct this situation by the introduction of so-called budgets—not scientifically prepared budgets, but merely compilations of statistics and estimates prepared by clerks and assistants. Budgets of this sort belong to that class of records which always are interesting but useless.

Value of Real Budgets Proved

Insurance companies can profitably draw on the experience and the research of industrial and commercial companies in regard to budgetary control of distribution costs. Individually, and through trade associations, these companies have been adapting the principles of manufacturing cost accounting to distribution costs, and through actual use they have proved the effectiveness of real budgetary control over such costs.

An intelligent application of the technique of cost accounting to the activities of insurance companies will give valuable information for the study of insurance cost problems and the reduction of expense. This technique can be most effectively applied by means of budgetary control.

A budget, when scientifically prepared, is a comprehensive schedule of actual quotas and allotments for a future period which must be met or bettered. It is under the control of the chief executive. Actual results are compared with the estimates period by period, and all marked deviations from the objectives that were set must be explained.

Budgetary control is a tool which must be specially designed to meet the needs of an individual company. Insurance companies have need of this field of accounting, and the following outline of the procedure for the installation of budgetary control should be of interest and value.

Analysis of Elements of Expense

Underlying a scientific system of budgetary control is the delegation of definite authority and responsibility to executives, department heads and supervisors. The insurance company must be func-

tionally organized throughout the home office, branch offices and field forces, and controllable units and lines of authority determined. In the average company the organization will remain unchanged; but in every case early scrutiny must be given to this point, so that if any adjustments are needed to facilitate expense control, they can be promptly made.

A chart of organization and a comprehensive analysis of current expenses will be needed for the consideration of the elements of expense. A wide columnar work sheet will be prepared, showing every department and section of the organization which can be construed as an expense center. Blank lines will be provided for centers not allowed for on the organization chart. The columns will be headed with the elements of expense, such as "Salaries," "Rent," "Traveling," etc.

Except commissions, the largest element of expense is salaries. A company in analyzing salaries will go down the salary column on the work sheet and place a tick mark in the space opposite every department which has a direct salary charge. In considering salaries, the question of special allowances will come up. The allowances may be fixed or variable amounts paid general agents, claim adjusters or others for services rendered the company. The organization chart has not provided for these centers, and they will be added to the list at the left of the work sheet.

Each element of expense will be thoroughly analyzed in this manner, and the tick marks will be coded to indicate directly controllable elements and indirectly controllable elements. Printing and stationery is an indirectly controllable element, as are most of the elements except salaries. One department may have need of an expense, but another may do the purchasing. The first department will have indirect control and the second department the direct control of the expense.

During the course of the analysis elements varying directly with volume of business, such as commissions and premium taxes with premium writings, and claim adjusters' fees will be identified as variable. All elements of expense will be qualified as variable, partially variable or fixed.

It is not essential for budgetary control but highly desirable to have such expense as attorneys', medical, inspectors', and claim adjusters' fees segregated by payees.

Analysis of Available Statistics

The next step to consider in preparing for budgetary control is the availability of adequate accounting and statistical data. Almost without exception the information in regard to premium writings, losses paid, commissions and taxes will be found adequate for budgetary purposes.

In regard to all forms of expense, however, the required data will not be available. A budget requires expenses to be analyzed for managerial purposes, with the elements of expense assembled to the centers (i.e. departments) of control. If a casualty executive questions the non-availability of such data, we suggest that he call for all available expense analyses of his company. He will probably find the general ledger accounts set up in accordance with the requirements of the convention statement. Loss expenses paid and inspection expenses paid will be by classes of business; and home office, branch office and field expenses will be totaled together by elements of expense. In addition to the general ledger record, he will find certain analyses of acquisition and administration expenses by offices and departments and even possibly by classes of business. It is possible that he will find inspection and loss expense analyzed by offices and kinds. The chances are that all detailed expenses have been influenced by the convention statement set-up and not by the needs of managerial control.

The expense analyses of life and fire companies are not so much at variance with the needs of the management, because the convention statement and consequently the company analyses reflect most of the expense by elements, although not with the exactness needed for budgetary control.

Chart of Accounts

The next step in the installation of budgetary control is the preparation of a chart of accounts. Such a chart is the work sheet, described under "Analysis of Elements of Expense," coded according to managerial expense account numbers and arranged for quick reference. The chart will also show a code for the insurance convention statement and schedule requirements. The chart will be in the possession of all employees having to do with the distribution of expenses.

Responsibility for Operation of Budget

Budgetary control, to be an effective aid to administration, needs the authority of the president or executive manager, and his is the responsibility for enforcement. He is aided in his judgment by a committee composed of the heads of the major departments. The detail work is delegated to an assistant of the president or to the person functioning as controller. Every department head and supervisor prepares estimates and is involved in making the budget.

In operation the estimates of the smallest section supervisors pass up through the line of authority and are assembled with department estimates, which in turn move up and are assembled with the estimates for the whole company to form the completed budget. All phases of the business are then coordinated in a careful revision of the entire budget; and, after final acceptance by the chief executive, it is not changed without his approval.

The budget committee informs the department and section heads of the approved budget for the particular parts with which they are concerned. As actual results are determined, these are reported to the department and section heads. Marked variances from the budgets of any items call for explanations from the department heads, and this necessarily draws their minds to the inevitable conclusion that their primary duty, no matter what their positions, is to see that the operation of the business results in a profit.

The Budget Period

Budgets are prepared for various periods, such as a month, quarter, half-year, year and sometimes longer. Insurance companies do not have a sensitive control of their operations, and a budget for a period less than a quarter is not practical for the business as a whole. In actual operation an annual budget in various stages of completeness will be best.

The first two quarters of the year will be in complete detail, and the last two tentative only, with totals unsupported by the detail required of the various operating departments. The budgets for the first two quarters will be subdivided into months in all operating departments involving expense which can conveniently and quickly be drawn off each month in time to be of use for budgetary control. Premium accounts current, and field and branch office reports which

do not come in until near the close of the following month, delay the comparison of actual results with the budget. In some departments it will be necessary to use an estimated actual pending the receipt of proved figures from the Accounting Department.

As soon as the actual figures of one quarter are completed and compared with the budget for that quarter, the detail in the second quarter following will be completed. As the results of each month and each quarter are recorded and studied, efforts will be directed to reduce excessive expense in the current and next month or quarter and to increase premium writings where they are below schedule.

Preparation of Estimates

With the budget period determined, budget instructions will be prepared in regard to the program, and work sheets will be distributed to all department heads and section supervisors.

The distribution will be progressive. The premium writings and the loss forecasts must be determined first. Then such departments as underwriting, claims adjusting, etc., will complete their budgets in order to furnish estimates on which the clerical, stenographic, filing and other service departments can complete their respective budgets.

As a general rule, estimates should be prepared by the individuals responsible for the performance of the departments or sections. The Accounting and Statistical Department will cooperate in giving records of past years and other data needed by the department heads.

As for the assembly of information regarding actual results for comparison with the budget estimates, certain statistical data will be gathered currently by department heads; but practically all of the work of assembling actual results will be carried on by the Accounting and Statistical Departments under the instructions of the budget authority.

The Premium Writings Forecast

The premium writings forecast may be a rough estimate based simply on the premium statistics of previous years; or it may be, as it should be, a definite forecast based not only on experience, but also on careful research as to the best sales policy. Such a forecast will be sound enough to be used for quotas.

The present home office statistical records provide ample data for a start, at least, on premiums by classes of business and by sources (state, agent, branch office and other). The premium writings forecast as finally approved will be tabulated and assembled for use as sales quotas, and for dispatch to the various departments which are dependent on it for the preparation of their budgets.

The premium budget will be prepared for each quarter of the year, and the first two quarters will be worked up in detail. Each month actual results will be compared with the budget. Each quarter's variations from the budget will be worked out and explained, and the detail of the budget of the second succeeding quarter will be completed.

Special agents, branch offices and others responsible for the acquisition of business will be supplied with actual writings records each month, and the budget variations each quarter. To be of value these reports must be submitted soon enough after the close of a period to be of use in stimulating business in the next period.

The Losses Paid Estimate

The losses anticipated for a future period will be merely estimates, for they cannot have the definiteness of a forecast. An estimate may be made for each quarter of a year, but the current quarter is the only one which can be worked out in any detail.

An estimate as to total dollars in losses paid is needed particularly for use in preparing the claims expense budget, and for use in estimating the net profit and financial and balance sheet budgets. Moreover, an estimate of the number of accident or loss reports and claims for a budget period is an essential part of a loss estimate, these figures also being used in determining the claims expense budget.

The Claims Expense Budget

The claims expense budget is more closely connected with earned premiums, insurance in force, and the loss estimate than with premium writings. The claims expense budget will be for the regular salaried organization of claim adjusters with established departments and offices, and for the variable fees and expenses paid outside adjusters. The problem will be one of cost accounting, with the number of loss or accident reports and claims as the unit of cost.

Each head of a claims office or staff will prepare a budget in accordance with the instructions. The budget will call for an estimate of the number of loss or accident reports and number of claims to be handled. It will give the number of employees by kinds, such as claim adjusters, clerks, etc., and the total. It will give the estimates of salaries, traveling expenses and other directly controllable elements of expense. It will also give an estimate of the use of stenographic service, supplies, etc. As far as the Claim Department is concerned, the quantity of such service and supplies is controllable, but the cost thereof is not.

The Claim Department will also estimate the number of loss or accident reports and claims which will be handled on a fee basis, and the average cost per report and claim. A tentative budget will give the total cost of the estimated number of claims. The final budget will give the total cost of the actual number of claims as determined by use of the estimated cost per unit. The budget comparison will be on the basis of estimated and actual unit costs.

The executive in charge of claims will assemble all estimates, and after analysis, revision and approval will prepare a consolidated budget to be submitted with the others to the budget committee.

Claims expense budgeting will be a more difficult problem with casualty companies than with life and fire companies.

The Claims Department will utilize its own and the Accounting Department figures to record its progress under the budget. Monthly figures will be reported, but the quarterly results will be the ones used for the more thorough budget comparisons.

The Acquisition Expense Budget

The budget for acquisition expense will be in two parts. The first part will be for internal controllable expense as incurred by the Agency Department, special agents and branch offices. The other part will be for external controllable expense, such as commissions and allowances paid and supplies furnished to agents. Commissions paid are variable with premium volume, and the budget for this expense will be on a separate schedule.

The estimates for the internal budget will be prepared by department heads and supervisors, and assembled for revision and approval by the head of the Agency Department. The budget for external expenses will be prepared under the supervision of the head of the Agency Department. Most of the items of expense in this

budget are due to the company's business policy and are controllable by the Executive Department.

Each month actual results will be compared with the budget, and each quarter the actual and the budget estimates will be analyzed, and the detailed budget for the second succeeding quarter prepared.

The General Expense Budget

The general expense budget will include all other departments of the company. A departmental budget will be divided into "internal" and "external." The external part will include the expenses paid in connection with outside service, such as medical fees, inspection fees and payroll audit fees. The internal part of the budget will be divided into directly controllable elements of expense, and indirectly controllable.

The indirectly controllable part will be estimates in quantities mostly. Where central stenographic service is used, for example, a department will estimate the number of letters that it will have typed. Where stationery, forms and other supplies are used, a department will estimate the quantities for the budget period. The Stenographic Department, the Supply Department, etc., will use a recapitulation of these estimated quantities in preparing their respective budgets. Estimated costs will be determined and distributed at cost to the departments using the service or supplies.

The budget estimates of section supervisors will be passed up through department heads, coordinated, revised and approved until they reach the hands of the budget committee.

Each month and quarter, department heads and supervisors will be informed as to the actual results and the variances from the estimates in those portions of the budget for which they are responsible.

The Underwriting Profit and Loss Budget

After all of the sectional and departmental budgets have been completed and assembled, two condensed budget statements will be prepared. One will be a comprehensive statement for managerial purposes, showing the detail and the totals by departments and by elements of expense, such as salaries, traveling, etc. This statement will have sub-totals such as acquisitions, inspection, general and

claims by branch offices, field and home office. The statement will also show unit quantities, i.e., number of policies, claims, etc., in order to determine costs per unit. Provisions will also be made for drawing off ratios of expense to premiums written and premiums earned.

The completed statement will facilitate the analysis of costs in various territories. For example, agents may report to the home office and have all of their dealings with the home office; or they may have some dealings with, and may or may not make reports to, a branch or service office.

In determining the cost of doing business with an agent or in a particular locality, costs will be accumulated as follows:

- Commissions
- Allowances and Supplies to Agents
- Special Agents (if any)
- Branch Office (if any)
- Home Office Agency Department
- Home Office General

The cost of allowances, special agents and branch offices in certain localities may be proportionately so high as to require a change in the method of handling that business. In the case of claims adjusting, a combination of a branch office expense and a home office expense caused by rehandling may indicate excessive costs, and call for an adjustment in handling claims in a particular locality.

The other condensed statement will be the convention statement, which will be of little use for managerial purposes but will serve as a check and interpretation in the customary arrangement. The statement will be worked out on a premium written and loss and expense paid basis, and also on a premium earned and a loss and expense incurred basis.

The final budget statements are designed to facilitate a ready monthly and quarterly comparison with actual results.

The Investment Profit and Loss Budget

Investment income in most companies is under close and intelligent scrutiny, and the principles of budgetary control are already applied. Investment expenses are budgeted in the usual manner. The investment budget is combined with the underwriting budget for determining the estimated net profit.

The Balance Sheet and Financial Budget

With the profit and loss budget completed, the balance sheet and the financial budget will be worked out. The profit and loss "earned and incurred" budget, and the balance sheet budget will be subject to monthly adjustment owing to the revision of loss reserves and of unearned premium reserves, as current actual results are recorded. The treasurer's department will have a more detailed financial budget for the guidance of the treasurer.

The Administrative Reports

The administrative reports in connection with budgetary control will be varied and serve many purposes. Budgetary control requires that to men in key positions shall be delegated the necessary authority and responsibility for team work, and for giving intelligent assistance in making the forecasts a coordinated, controlled and flexible "net profit" schedule. Every department and section head is his own cost accountant, and most of his work in connection with the budget will be in constantly devising means of carrying out and bettering, if possible, that part of the budget for which he is responsible. As ways of lowering costs are devised, the reductions from the estimates will be reflected in the next budget prepared.

Each of these key men will prepare and receive reports peculiar to his respective department. Some of these reports will be for his information only, and others for his and that of the Executive Department. The Executive Department will receive budget reports in condensed form reflecting the larger aspects of the company's activities. In order to avoid the waste of time and possible confusion in studying a mass of detail, the executive will depend upon special reports involving comments, criticisms and suggestions in regard to excessive expenditures and situations which demand correction.

In addition to his regular duties, every individual in a key position must each do his part in making profit by saving expense. The Agency Department will be working for profit in its sales efforts.

Advantages of Budgetary Control

Budgetary control is simply an intelligent and practical way of utilizing the facts about one's business which have been ascertained through experience and research. It is profitable because it discovers

and critically examines the smallest item of expense, ascertains which are essential, and points the way to the elimination of waste motions, useless functions, extravagant methods and other sources of loss.

Budgetary control, when kept flexible, is an effective aid to intelligent administration. It is a schedule for attaining the desired net profits; and no insurance company is too large or too small to be helped by such a scientific study of its potentialities for profit making.