BUDGETING: A SYSTEM FOR PLANNING AND CONTROLLING EXPENSES

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William F. Dowling's paper "Budgeting by Casualty Insurance Companies" was presented to this Society in May of 1942. He noted that some twenty years before budgeting was primarily used to control governmental appropriations and expenditures. He also reported on a survey which showed that about one-third of the companies were budgeting expenses in relation to a forecast of income. Budgeting had come of age and he was certain the time had come for its widespread use by casualty insurance companies.

Unfortunately, budgeting has not achieved the role predicted for it. Indeed the lack of progress is clearly evident in Francis Perryman's summation of a CAS seminar on "Modern Systems of Expense Control" held in 1958:

> "All in all, I think the companies are using what they call a modern system of expense control but which is the old time New England thrift, just watching the store a little more closely, in this time of bad underwriting results."

Progress has also been notably slow in the development of cost accounting systems the need for which was first described in our *Proceedings* in 1916 by Claude Scattergood and numerous times since.

The lack of progress is perhaps attributable to a lack of appreciation of the potential benefits and the fact that most accounting systems are hard pressed to satisfy statutory requirements. At such time as the accounting burden is shifted to the computer an opportunity is created to remedy the latter deficiency. This paper is presented with the hope that it will create an appreciation of the potential benefits of budgeting for the current generation of actuaries who may never have read Dowling's paper but may now be encouraged to do so.

Expense control has much the same connotation as thought control. It sounds unpleasant and undemocratic. Budgeting doesn't have a very good image either. For this reason, as well as to be more descriptive, budget systems are sometimes called management planning and control systems. The emphasis is on planning but the real payoff is in the control that can come from the planning. "The old time New England thrift" linked with planning in a sound budget system can produce results. Consider two examples:

The key to General Motors success, according to a recent report,[1] is "cost awareness in every detail up and down the managerial ladder" and a budget system in which "top management expects and gets detailed reports from division people on performance as measured against agreed upon goals."

The improved profit performance of Eastern Air Lines has been described[2] as the result of careful planning in place of penny pinching. "The biggest single thing that turned Eastern around last year," said Senior Vice President Arthur D. Lewis, "was that we stopped telling our people they had to do something and started telling them, 'Here's the way we're going and here's where you fit into it.' "

Features of the more successful systems in operation today are:

1) a heavy accent on detailed planning related to long term profit objectives;
2) involvement and support of all levels of management;
3) identification of unit costs for reasonably homogeneous repetitive activities;
4) an examination of all expenses for their "cost effectiveness";
5) a detailed analysis of significant differences between actual and planned results to establish cause.

The inadequacies in budget systems may arise from any of the following:

1) lack of chief executive support;
2) lack of understanding of system;
3) little or no planning;
4) lack of a focus on profit;
5) little or no flexibility;
6) poorly defined responsibilities.

Slogans to the contrary, a company should know what it is doing right (and what it is doing wrong). It should know what policies are profitable

[1] *Business Week*—May 8, 1965.
[2] *Business Week*—March 13, 1965.

and in which geographic areas. It should know how adequate the rate levels are by state by line of insurance and by class. It should know the kind and volume of business of each of its producers and how profitable their business has been and is likely to be. It should also "know" what is likely to happen in the marketplace in the next five to ten years. What changes in claim frequencies and average claim costs can be expected? What should we do to achieve the best results possible over the long pull and in the coming year?

Management should evaluate the reasonableness of plans in relation to past results. Plans that are too ambitious may be suspect from the start and accordingly lack the full support required for maximum performance. Overly conservative plans may be achieved but the company has been deprived of gains that should have been made and flabbiness may develop that will hurt when the going gets tough.

The overall plan must be made up of detailed plans in which the objectives are translated into requirements for each of the responsibility centers (organizational entities) within the company. The head of each responsibility center should participate to the extent that he can contribute in those areas in which he is uniquely qualified.

The production potential of the company should first be assessed. This should be based on information and recommendations furnished by each field office. A determination should then be made as to the best areas for expansion and in which areas contraction is advisable. It is in this process that knowledge about the company's sources of profits and losses is applied so as to reach a marketing plan with optimum profit possibilities.

The marketing or production plan must be in a form that makes it possible for the head of each responsibility center to determine the center's work load or role in meeting the objectives. Responsibility center heads who receive service from other responsibility centers should obviously transmit their needs before the service center heads can determine their work loads.

With the company's objectives translated into the work load for his area of responsibility each center head is in a position to determine his manpower needs. These can be converted to expense dollars for salaries, salary increases, and overtime which make up the bulk of budgetable expense. Other expense requirements such as travel, toll calls, supplies, postage, dues and fees and equipment rental can also be estimated.

The quality of performance should be specified since this may affect the staffing and expense requirements. It may be possible to economize where quality of performance or speed can be diminished without adverse effect. It makes no sense to pay the price for processing on a current basis work that is more economically handled by allowing backlogs to accumulate during peak periods.

It is considered desirable to charge centralized services to the users of the service since the users determine the volume of service provided. Where this is done it is important that the user have a voice in setting the specifications for the job to be done. This service is then "purchased" at a predetermined rate per unit of work.

By giving primary attention to the cost of processing an additional unit of work a method of allowing more budget dollars for more work is found which produces a more equitable basis for judging performance since, in most cases, the volume cannot be controlled by the head of the unit responsible for processing the work. Because of overhead costs it is apparent that wide shifts in volume will affect unit costs—and this fact must be considered—but within a narrow range of volume it is simpler and sufficiently accurate to ignore the oversimplification. This is called variable budgeting and introduces flexibility in the budget system.

The budgets for each responsibility center should be reviewed by the next higher level of management. In this review it is necessary to distinguish between those efforts and expenses necessary to meet the current year's profit objectives and those aimed at longer range goals. Whatever adjustments are made in these budgets, such as may result from projects eliminated, slowed down or deferred, there should be an understanding and acceptance by the individual responsible for achieving the agreed-upon budget results. He should accept the fact that he has contracted to produce specific results and will be held accountable for their achievement. In this way budgeting provides a communications network for translating company objectives and for transmitting them.

The effectiveness of the budget system is diminished where management fails to delegate its authority for planning and execution. Delegation is facilitated with a budget system because it provides a means of identifying responsibilities and measuring performance. Budgeting can then be made a basic part of the management job rather than an exercise for allocating expenses.

While planning is the major part of budgeting it is in fulfilling the plan that the benefits are realized. Monthly reports compare results—expenses and accomplishments—with the plans. The variances from plan indicate differences between actual and planned results and, if significant, should be investigated. When the reasons are found, appropriate administrative action should be taken. Reports measure the performances of all the heads of responsibility centers which are accumulated for presentation to succeedingly higher levels of management. The president gets a report which identifies the results achieved by each department head who reports to him. As the plans for the year are carried out the emerging strengths and weaknesses can be traced to their sources.

Budgeting stimulates expense control because the head of each responsibility center knows what is expected of him. He is in the best position to take appropriate steps on a day to day basis to insure favorable results. Concern for expenses is communicated to each individual in the company. It becomes obvious that efficient operations are essential to improve budget performance. More effective use of everyone's time is seen to be directly related to the achievement of company goals.

The way management uses its budget system is important. If problems are not investigated and variances are not taken seriously the system is of little value. On the other hand, too much dependence on quantitative results and variances without looking for the underlying causes can lead to inappropriate action and create fear and mistrust of the system.

Blind faith in the system is not enough. As Charles R. Mortimer, General Foods Chairman, said at Columbia in 1965 while agreeing that there must be goals, plans, and organization for a large company to prosper, the essential ingredient is the "right kind of man." He added, "right decisions are what build profits and produce growth, and decisions can only be made by men."[3]

Perhaps the most compelling argument in favor of a system for controlling expenses through planning directed at specific profit goals, evaluating the resources needed to accomplish them, and reporting results which are identified with the responsibilities for achieving them is to consider the consequences of failing to do so.

DISCUSSION BY PAUL M. OTTESON

Mr. Foster's paper stresses the importance and necessity of a system of planning which will permit comparison and subsequent analysis of variations between actual results and planned results.

The lack of progress in the insurance industry concerning development of cost accounting and budget systems is attributed to two reasons:

[3] *Business Week*—May 1, 1965.