

Is It Time To Move To Expense Allowables?

Every year, around this time, the strategic planning process starts. And a key element in most companies is the agonizing process of identifying, negotiating and ultimately compromising on the budgets for next year. Everyone hates it, but it's something that must be endured because budgets are a necessary part of the management process.

But are they, really? First, they don't really work all that well. They are based on sales, revenue and other assumptions that rarely end up being as they were planned. The real world is in constant change but budgets can't keep up. They are set in concrete sometime this year. This is always too far ahead of reality to be accurate. Attempts next year to adjust them so they keep up with your monthly results never work well.

When you try to make necessary changes based on the reality of what's happening, many managers cry foul and want to renegotiate. If this has happened to you, it's an indication that you have a serious organization flaw. Not enough people are focused externally, towards the real world, where customers, agents, competition and the economy sometimes act in unreasonable and unpredictable ways. Instead, they live in a rational, controllable world where success depends on internal relationships and measures. And the budget process supports this viewpoint.

The best designed companies have everyone focused on the results they can control within a setting that also ties them to the business realities the company faces on a day to day basis.

Another problem with basing expense management on budgets is that they are the result of negotiations and other subjective processes that are inherently flawed. Looking back you can see this. Some areas clearly had too much money, others not enough. Interestingly the ones with too little usually do surprisingly well. You can also see that many managers who came in "under budget" were successful not because they were good, efficient managers but because they were good negotiators and negotiated a budget that was easy to attain.

In summary, the budget process in many companies is a time consuming process that creates unnecessary stress throughout the organization. Each year you try to solve the same problem -- how much money will we need to spend next year to efficiently attain our goals -- with a process that tends to look at everything as brand new. But everything is not brand new. Most of the assumptions and results you need are basically the same each year and can be reduced to formulas. Why not solve it once and then just make necessary adjustments for what is truly new for next year?

You can do this by switching to a process where you create "expense allowables" for the total company and for each of your key areas within the company. (If you're unable to take the major step of discarding your current budget process, you should at least consider this analysis as a way to ensure that your final budget results are within allowable parameters.)

What is an expense allowable? It's a formula that determines how much money a team or unit can afford to spend, based on the what they do and the value they bring to their stakeholders. When this process is brought down through a company, it results in each team or unit becoming a mini profit center, where their revenue varies in understandable and manageable ways and their goal is to manage both the revenue and their expenses to attain a positive result -- an operational profit.

These formulas are tied back to the company's long term strategic plan and the pricing assumptions in the products and services you sell. This results in a very powerful operational "engine" within the company. It can be a key element in creating an "ownership culture" throughout the company based on real world accountability. It can also be the basis for a new form of variable compensation -- a Gainsharing plan where teams and units share in the operational "profits" they create. But perhaps the most powerful concept is that each unit has a goal of beating their part of the pricing assumptions for the products they work with. And this

applies to every unit in the company, not just the ones that work directly with your policyholders and other customers.

It creates an environment where the principles of sound business management are learned at all levels within the organization structure.

Creating expense allowables requires work, patience and corporate resolve but the advantages are well worth the effort. Here are the basic things you have to do to create expense allowables down through an organization:

1. Analyze and understand what your expense picture has been for a reasonable historic period. In most companies this is three years.

Most companies do expense analyses at a company level every three years. This is a good starting point. For this analysis, however, you need to carry the analysis of why expense levels changed down through at least the major organizational entities in the company. Eventually this analysis needs to be done for every team or unit. You also need to understand and sometimes change the way unusual situations are handled.

2. Identify the key drivers, reasons why expenses vary in each area. You need this information to create the formulas that will create the team or unit's "revenue."

This is usually more difficult than you initially expect. You want to make sure that the "drivers" you select get you the behaviors you need. For example, if you were doing this analysis for a new business issue team, the most obvious "driver" would be applications received. But if you provide expense revenue to process applications what you'll get is a team of people that want to process as many applications as possible. This doesn't do the company any good. What the company needs is issued policies. Having this as a driver also gives this team a solid reason to connect with its agents to reduce the level of wastage (apps received but not issued) and ensure that as much good business is placed on the books as possible.

This example also highlights the need for each unit to have complete and balanced success measures in addition to good expense management. Good expense management is great but must be balanced with the level of attention to ensure good loss ratios, for example.

3. Identify and analyze the pricing formulas and expense assumptions in your key products to determine acceptable expense levels for key areas in the company.

Performing the first two steps creates an understanding of how the company's expense world is and was. This step creates an understanding of how it should be. Once you perform this analysis you'll also want to build the process of revising expense allowables into your pricing process.

4. Determine expense allowable formulas, test and adjust as needed.

In this step you take all of the information and analysis and develop the actual formulas and benchmarks that will be used. Depending on how far various units are from being at an ideal expense situation, you may need to phase some benchmarks in over a year or two. The goal, however, is to have every team and unit strive to control their expenses -- with the result that the company will consistently create an "operational profit," i.e., a real profit by providing your services at a cost that is lower than the assumptions in your pricing formulas.

As you can see, this is a very powerful concept. It's not radical. It's very logical and it works well. But it takes effort and commitment to put it in place. Once you have it working, you'll wonder why you didn't do it sooner. You'll also see other things more clearly, like the advantages of having complete, balanced success measures for every unit in the company.

If you'd like to discuss this further, please call me or visit our website at McDonaldConsultingGroup.Com. We'd be very happy to help. It's what we do.