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**PROFIT CENTERS -- MANAGEMENT REPORTING**

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MR. RICHARD S. ROBERTSON: I'm a strong advocate of the use of profit centers as a management tool and as a financial reporting tool. I would like to talk about my general philosophy towards profit center accounting and to share with you some of my experiences at Lincoln National with profit center accounting and with work I have done with others. I have been working on Lincoln National's financial reporting now for about 13-14 years and for most of that time we have been building our profit center accounting system. So we have got to the point where we have a pretty sophisticated system. Like a lot of things that work well, there are a few things that need fixing, but I think you might enjoy hearing some of the things we have done, why we are doing them, and how well they work.

The idea of profit center reporting is not new. Alfred Sloan installed this kind of system decades ago at General Motors. The insurance industry has been

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relatively slow to pick up on it. Over the last 10-20 years, however, I've observed a significant movement away from functional organizations toward profit center organizations.

One of the difficult problems in managing a large and complicated organization is to develop some kind of process whereby each operating unit can determine what it needs to do to contribute to the corporate objectives; to develop a system whereby the management of the corporation can evaluate the extent to which a business unit is contributing to the corporate objectives; and ideally to create some incentives to make it advantageous for the people managing that unit to make the proper contribution. That is essentially what profit center accounting is all about. We're trying to develop a system for articulating what it is we expect the business unit to do, for measuring the extent to which the business unit is accomplishing what we want it to do, and for rewarding the unit or penalizing it to the extent that it does or does not do what we want it to do.

We have installed a profit center accounting system in practically all of our operating units and have decentralized the operations of those units. Each major business unit has practically all the resources it needs to operate in its business. Each is responsible for pricing, products, marketing, compensation, administration, financial reporting, investments, data processing, and in some cases even such functions as law. We then use the financial reporting system to hold the unit accountable for its performance. Each of these business units generally will subdivide its own operations into smaller profit centers. In many cases there may be sub-profit centers of these profit centers, so we get a tiered organization.

If we were to draw a chart of our overall profit center accounting, it would look very much like a classic organizational chart with the corporation at the top, the operating divisions on the next line, and the subdivisions and sub-subdivisions farther down. In some of our units we are able to take profit center accounting down to extremely low levels. In our property-casualty operations we have what are essentially profit centers at the agent level -- at least we track an agent's results. We measure the contribution the agent is making to the overall corporate earnings. In the group insurance and the reinsurance areas, we often track it down to the account level, so we know the extent to which an account is profitable or is making a contribution.

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In general, our interest and desire to develop profit centers at this lower level is a function of our ability to make decisions that will affect that profitability. In the three areas I mentioned -- property casualty, group, and reinsurance -- we are making pricing and underwriting decisions on an ongoing basis, on an account-by-account or agent-by-agent basis, so it is very useful and helpful to have that information. In some cases we can pay people responsible for agents or accounts based on the contributions that their agents or accounts are making to the overall corporate profitability.

On the life insurance side, we generally do not move the profit center accounting down quite as far, because we don't have as much control on a month-by-month basis over the things that are going on. The usefulness of the information is a key element in determining how far down we want to take our profit centers.

We have been less successful in using profit center accounting for staff functions. We do some things that have elements of profit center accounting for practically all of our staff functions. We certainly have cost centers in all of our staff areas. In many cases we generate a revenue stream so that we do in fact have a profit that is generated. The Law department, for example, fills out its time on an hourly expense basis, not unlike the way an independent law firm might. The clients are the business units that use their services or charge for their services on the basis of this formula.

But a Law department, or most staff departments, really can't function the way we expect an operating profit center to. In an operating area there are, in the final analysis, a couple of ways that profits can be improved. You can either increase revenues or reduce expenses. We're not sure that we want our Law department to be drumming up business in our operating units. We want them to do what is necessary, but we don't want them to make work simply to increase the revenue report of the profit center. That doesn't help our corporate objectives a bit. On the other hand, we want them to do the work that needs to be done. While we don't want them to spend money unnecessarily, we also don't want them to reduce the cost just based on a judgment that there is something the business unit wants and they don't. So they are really completely subject to the demands of the operating units and don't have a great deal of control of either side of the income statement. As such, the profit statement is not a very

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powerful control device for them or for most staff units. For some staff units, it is not even possible to go that far. It is very difficult to generate a revenue stream for, say, a human resources department. We don't even try for our controller department, for example, or for internal audit.

One byproduct of profit center accounting, perhaps even one objective, is to develop a system whereby we can apply incentives for operating units to do what we want them to do: to install incentive compensation at an operating unit level; to have a basis whereby we can examine the results of an operating unit, determine whether they've done a good job, go back to them and use the financial measurement we have established to explain the extent to which they are or are not contributing to the corporate objectives; to base merit reviews on all the incentives built into a corporate structure.

As we do this, it is critically important that we use the right measurement. It is not easy. We may have a system that says the unit is doing well in something that harms the corporation as a whole, or possibly is neutral in terms of its impact. Either the units are going to do what we are paying them to do and the corporation will suffer, or we are going to have to tell them to ignore what the entire profit center system is telling them and to do something else that is in line with corporate objectives. Either one is not at all constructive.

The natural measurement for profit is earnings. In our case, we are using operating income on a GAAP basis. For reasons that I think are clear, statutory earnings do not work well for many of our operations. In many cases, with statutory earnings, when you do good things earnings go down and when you do bad things earnings go up. That creates the kind of disincentives or problems that result when you use the wrong measurement.

We have found that in the great majority of cases, GAAP income is at least directionally appropriate, and in fact it is better than that. It generally puts about the right value on things that happened, so it is doing a pretty good job of measuring what the business units are contributing to the overall corporate objective. But it doesn't always. As you know, there are many situations where GAAP income is not appropriate. For one thing, it is a measure of current income produced by an operation and does not place a great deal of value on future income.

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So if a business unit is using as its objective the maximization of current GAAP income, it would be very reluctant to make investments in the future -- investments in things that will produce business next year and earnings afterwards, which we as a corporation consider vital to our long-term success. I can think of one situation where we have a very heavy incentive system. It's a buy-out where we constructed a formula to measure the earnings contribution that the acquired unit is making to the company. We told the management that over five years we would be paid a certain percentage, and a relatively high percentage, of that contribution. The problem is, if we don't watch out, they will use that formula to maximize the income right to the end of the earnout period and put absolutely nothing into the development of the future. We'll be left with a shell at the end of this period of time. They're not going to do that; they understand that that's not appropriate. But we're going to have to do something with the incentive system so that we are not paying them for something entirely different from what we want them to do.

In many cases there is a conflict between the profit center measurement and the long-term objectives that we expect the business to accomplish. Possibly we could put together longer term incentive programs and they can work quite well. But as we get down to smaller and smaller profit units, people move around a lot. They'll move from one profit center to another, or they'll be transferred from one operating unit to another. That makes it difficult to retain the long-term incentive situation we are trying to build. I suppose it can be done. We haven't done a great deal of experimentation in this area. Practically all of our incentive programs at the operating level are short-term in nature.

I mentioned that we used operating income. Actually, over the last few years we have been moving gradually, not away from operating income, but to a variation of it. Many years ago we were a surplus rich company. We had built up a very high level of statutory surplus and of GAAP shareholders' equity to the point that we had a serious problem reproducing an adequate return on equity. We were seriously underleveraged. We also did not have much incentive to manage that surplus efficiently. Anything that produced a return higher than what you could get by investing in corporate bonds, or whatever we were using as our primary investment medium, produced an increase in operating income for the company. To the extent we had no good alternative uses for that equity, it was probably to the benefit of the stockholders. One might argue that if we

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have all that equity, we're better off distributing it to our stockholders rather than keeping it. I suppose that was part of the problem. Our stock traded at a rather low multiple of book value as a result. We have, through a variety of processes, moved away from that to where we are now, along with most insurance companies, surplus poor. Surplus is a resource which we have to allocate to the areas that have the greatest return. We have to compete in the equity markets and compete in the capital markets for surplus. So we want to give our business units incentives for efficiently managing equity.

Absent those incentives, one way to increase operating income is simply to grow, to acquire more business. It doesn't really matter how much you have to invest in that business as long as you can get that incremental investment return over what you can get by simply investing it. So, partly to correct that, and partly to create incentives for people to effectively use surplus, we have generally moved to return on equity as our primary measurement of operating performance, both at the corporate level and the operating unit level. That has some problems too. We have to be very careful how we define equity. By creating incentives to use equity effectively, we have also created incentives to run more highly leveraged operations, and we have to take great care at the corporate level to monitor and to define what leverage operating units are allowed to use. We have extensive discussions over appropriate levels of surplus for various parts of our operations. But on balance it has created very strong incentives to efficiently manage that equity as a corporate resource.

Another problem with profit center reporting is that it does create competition between operating units, and between operating units and the company as a whole. In effect we are paying people to focus on what's good for their business alone. We are not paying them to help out their brother down the hall or across the street. Left unmanaged, we would lose a lot of the value of having a large organization. We would lose whatever synergy there is from having different operating units participating in similar businesses, and we could create conflicts between units that from the outside would look quite silly -- units competing for the same agent's business, for example, or units competing for employees. So there is a need to put some relatively strong management in to be sure that these conflicts are minimized, or when they do come up, to have a mechanism for resolving them. We've got to be alert for things that are going on in an operating unit, created because of the incentive system, that cause

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problems for the rest of the organization, and that do not in fact contribute to what we are trying to do corporate-wide.

Controls are very important. One of the problems we have is that each operating unit usually has its own financial staff. Certainly at the major operating unit level that's true. We feel that this is necessary because so much of the accounting process is tied in with the administration -- the booking of premiums, the payment of commissions, or whatever. We did not feel that it was desirable or efficient to establish a large corporate accounting unit. But this means that the people who are determining the financial performance of a business unit are subject to the control of the management of that unit. It means that they must be people of very high integrity, willing to stand up to their management and say, "No, this is not the way it is, I cannot report that to the corporate office. I must do it the way it is supposed to be done."

It also means that those of us in the corporate office must exercise a strong degree of control. We must maintain a high level of communication with the financial people in operating units. We must have a series of secondary controls to be sure there's not something going on in that operating area that we don't want happening. We need a strong audit facility. We need to have a company that is organized, like ours, along profit center lines with the financial function decentralized. It is going to have a significantly larger audit function than one that is functionally organized or one that has a centralized accounting function.

The profit center accounting system is a management tool. It is not the management of the company. We cannot let the accounting run the company. If what the profit center accounting system is telling us is the wrong thing for the company, then we have to override the accounting system, or override or change the incentive system. It is important that we have management in place both at the operating unit level and the corporate level to understand the strengths and limitations of the profit center system and know when to step in and make corrections. Now, sometimes these are difficult because you've been telling operating people for months or even years that here is what they are expected to do and here is how we are going to measure their performance. Now we're coming along fairly late in the process and saying, "That's not what we wanted after all. We have to ask you to do something different." Often you have to change the incentive program at that point, and it is not fair to tell the operating

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people we are going to pay for this and then take it away. At a minimum you have to do a very effective communications job of helping them to understand what's happened, why, and why you need something else, and to help them regain confidence in the financial reporting system.

Let me talk some more about specific issues that typically come up. Expense allocation is always one. We don't think it's necessary to allocate every bit of expense. If we were in a mutual company environment, we might well come to a different answer. But the important thing here is not tracking down each unit of expense, but to develop management tools to do the best job. So we tried to limit the expenses that we charge a business unit to those that it has some degree of control over. On the other side, we try to give them as much control over expenses as possible.

For example, in the Law department situation we expect the business unit to largely control the amount of legal services it utilizes. There are some limits on that because there are some corporate legal needs that have to be imposed, but by and large we want them to be the ones that are controlling the efficiency of the Law department. The same thing works for Data Processing and even some of the Human Resources functions. So to the extent possible, we try to develop systems where expenses are charged on an "as-utilized" basis.

In other cases we try to develop systems that charge expenses according to what a reasonable cost for those services might be, even if it is not a direct charge. We don't charge some expenses at all. For example, the primary customer of the Audit department is not the unit being audited, it's the corporation, the shareholders, the Board of Directors. While you can make a case that each unit certainly has to make enough revenue to support that function, the fact that we don't want those units second-guessing the extent to which we subject them to audits means that we decide it is easier to absorb that cost at the corporate level before corporate overhead. We also do that for some of our other corporate functions. My own office, for example, is not charged, nor is the chief executive office. The principle at work here is that it is not absolutely necessary that the sum of the profits of each of the profit centers equal the profit of the corporation as a whole.



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It is desirable, to the extent possible, that the profitability measure we use bear a reasonable relationship to the measure we use for corporate profitability. It is easier for people to understand their contribution to the corporate progress if they can see that relationship.

But it is not necessary for every penny of profit at the unit level to show up in the aggregate profit of the corporation. This especially happens when we get down to the lower level profit centers. For example, we keep track of profits for each property casualty agent. We don't try to allocate all the corporate expenses that we have to that agent. We just look at his commission and perhaps some small level of additional expenses that are used to support him. Then we expect a level of profitability that produces enough revenue to support all those other expenses that are beyond the agent. This tactic produces a profit measure that we can use to understand and control what's going on. We know, when it is not adequate, that some action needs to be taken. The agent knows that if it is not adequate, action will be taken.

Similar comments apply to what we do with investments and investment income. To the extent possible, we try to directly allocate investments to business units. At the major corporate level that is done explicitly. We have separate accounts for all our major business units. There are clearly limits, however. We are not going to have a separate investment account for each group account or each property casualty agent. In fact, we don't even allocate the investment income there. *We recognize that part of the earnings will come from the investment income.* But in the interest of having something simple and useful, we can get by without that.

We don't allocate investment gains and losses directly, and there are some problems with that. There is a tradeoff in investing for gains and losses and investing for income. There is usually a tradeoff between the realization of an investment gain or loss and the realization of investment income. If, for example, we have some high yielding investments that were made when interest rates were higher than they are now, we could probably sell those and realize capital gains, but we would have to reinvest in a lower dividend return. As a result, future operations could be penalized. The value of that penalty would be essentially the present value of the gain we take. So we have processes for reallocating that investment gain to the years where it would have been if it hadn't

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been realized. We do a similar thing for investment gains and losses. These are the kinds of things that you have to do to avoid creating incentives to do the wrong thing or to not do the right thing.

MR. JOSEPH FAFIAN, JR.: To discuss management reporting, or management information, as I like to call it, we must begin by asking ourselves a question. What is it we want information about?

To answer that question, let's examine what the key success factors are in the life insurance industry. The first is obviously management. Management must have a clear vision of where the company is going and how it is going to get there. Management must develop plans that will make the company stand out from its competitors. But, equally important, management must be prepared to take corrective action when deviations from planned results occur, and deviations from plan do occur. Financial reporting should be the tool that identifies deviations from plan. Financial reporting should also be the tool that begins to define what corrective action is required.

The next key success factor is a company's distribution system. In order for a company to succeed, it must have a distribution system that produces large quantities of quality business. Financial reporting should be the tool that measures both the quantity and quality of the sales results of the distribution system. Financial reporting should also be the tool that identifies when corrective action is required with respect to the distribution system.

A third key success factor is capital. Financial reporting is the tool that tells us whether capital is adequate, inadequate, or redundant.

A fourth key success factor in the life insurance industry is how well we do pricing products. Financial reporting should be the tool that measures actual results and compares them to the pricing assumptions. Can you imagine a widget manufacturer that doesn't really know how much it costs to produce the widgets yet goes on selling them? Yet some companies in the insurance industry seem to follow what I call the Satchel Paige theory in evaluating how well they've done in pricing. The Satchel Paige theory is "Don't look back, someone may be catching up to you."

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The fifth key success factor is expenses. Financial reporting is the tool that measures actual results and compares them to planned results, pricing assumptions, and, if appropriate, GAAP assumptions.

The sixth key success factor is underwriting, and by underwriting I don't just mean the assessment of the claim risk, I mean the assessment of the persistency risk as well. Financial reporting is the tool that enables one to compare actual to expected claims, lapses, and surrenders. This tells us how well or how poorly we're doing on underwriting. One short period of time, such as a quarter or a year, may be insufficient to tell us that we are doing well, but very often it is adequate to tell us that we are doing poorly.

Finally, the seventh key success factor is investments. Again, financial reporting is the tool that we use to compare to pricing, etc.

So as we look at the key success factors in our business, we can see that financial reporting is our scorecard. It the tool that tells us what we are doing.

We can also look at it from the point of view of what kind of information we want, and that means examining sources of profits from life insurance products.

As you all know, the bottom line of a life insurance company is essentially comprised of five elements that are generally referred to as sources of profits. First is the pricing margin built into the product when it was developed. Then come the gains or losses from persistency, expenses, claims, investments and taxes. Financial reporting is the tool that's used to measure gains or losses.

With that as background, I will be looking at financial reporting and discussing it from two points of view. First, what is the purpose of financial reporting, and second, what are some of the ground rules that I believe should be followed in establishing a financial reporting system.

As I see it, financial reporting has two basic purposes: to determine how we are doing, and to determine how we can do better. Let's begin with, "How are we doing?" The best way to get an answer to that question is to look at each source of profit in a life insurance company. Let's look at sales or that portion of the profits or losses that comes from the pricing margin built into the

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products being sold. Naturally, you begin by comparing the actual volume of sales with what you assumed would be sold when you prepared your plan for the current period. But that only answers one question -- are sales ahead of or behind plan? To answer the question of how are we doing, we have to dig a little deeper.

First, let's examine production by source. You're looking to see if your production is coming from a few concentrated sources. If it is, your future is vulnerable. I always became concerned if any agency of the company I ran accounted for as much as 20% of the company's business. I didn't want that agency to write less business. I wanted our marketing people to go out and recruit an agency of equal size.

At the other end of the spectrum, you look to see if production is coming from many sources. If most of the sources of your business are not making their living selling life insurance for you, again, your future is vulnerable. With today's cost of doing business, agencies that are producing less than about \$50,000 per year of annualized premiums, are probably not going to be with you over the long haul. Either they'll fail in the life insurance business or they'll direct the business they are writing for you to their prime carrier.

In addition, when you examine production by source, you want to see if there have been any dramatic changes in results. Has a small producer suddenly become a large producer? If so, you want to find out why. Has the agency begun to place a larger share of its business with you? In that case you're doing great, provided the business is profitable. Or has some other company terminated the agency's contract because of poor persistency, and the agency has had to find a home for its marginal business?

The next thing you want to look at is product mix by source. Are there any single product agencies among the production sources? Unless you are a single product company, that is usually a tip-off to one of two problems. It might be that you are underpriced on a particular product. Hence, when the agency needs that product, they come to you for it and place the rest of their business elsewhere. Or it might be that the agency uses a canned sales track and sells only one product. In that case, future persistency is probably a concern.

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So when you look at sales, you want to be able to tell whether or not you are achieving the margins from sales you expected. Financial reporting must tell us how are we doing and why with respect to sales and pricing margins.

The next thing to look at is persistency. You can begin by examining your overall results and comparing them to your current year's plan. You also want to compare the current results to your pricing assumptions and, if appropriate, your GAAP assumptions. This answers the question of whether overall persistency results are tracking with plan. But it does not answer the question of how are we doing. To get this answer you have to dig a little deeper.

What are lapses by production source? All the conservation efforts in the world will have little value if the business was improperly sold in the first place.

Once an agency with poor persistency is identified, you want to do two things. First, look at the agency's persistency by producer. If there are a couple of bad apples in the barrel, the solution is to terminate those agents or brokers. Or if there is a persistency problem on most of the agents, you'd probably want to terminate the agency. Second, you want to look at the persistency of other agencies recruited by the sales officer that recruited the poor persistency agency. Do his or her other recruits also have high lapses? If so, you may want to terminate the sales officer.

After examining lapses by production source, you want to look at them by product. Is there something in your product design that encourages lapses? For example, on the traditional products, is there some kind of precipitous jump in the second year premium that's impacting your persistency experience? Finally, you want to look at lapses by product and production source to see whether or not this reveals any new intelligence. Financial reporting is the tool that tells us how we are doing and why with respect to persistency.

The next thing to look at is expenses. In total, are expenses under or over budget? But again, you want to go deeper. You want to know, by cost center, how expenses are tracking versus budget. Which expenses are over plan, which are under plan? You want to know how expenses are tracking versus pricing assumptions. If sales are over or under plan, has there been a corresponding change in expenses? Are any cost centers spending what they originally

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budgeted even though their activity is different than planned? You also want to know how expenses are tracking versus GAAP assumptions, if those assumptions are different from the pricing assumptions.

This three-dimensional look at expenses will quickly tell us whether or not corrective action is required. Financial reporting must tell us how are we doing and why with respect to expenses.

Next, we want to look at claims in four ways. First, how are we doing versus budget? Are total claims tracking with what's been projected? Second, how are claims tracking versus pricing assumptions? While total claims may be on track, how are early year claims versus what's been assumed in pricing? Third, how are claims tracking versus GAAP assumptions, if those assumptions are different from pricing assumptions? And finally, you want to look at some durational analysis. For example, on small group health business, an aggregate loss ratio is usually meaningless due to the impact of either a preexisting condition clause, or some initial underwriting. You have to examine results by duration. An increase in new business may have a positive impact on overall loss ratios. However, that doesn't necessarily mean that the experience is acceptable. So financial reporting must tell us how are we doing and why with respect to claims.

Next we want to look at investments. Again, you begin with an overall comparison. Is investment income ahead or behind expectations? However, the answer to that question does not necessarily tell us how are we doing. You have to dig deeper.

How is investment income tracking versus budget? How did cash flow compare to budget? How did the yields on new investments compare to budget? How did redemptions or sales of existing investments impact future yields?

How does investment income stand versus pricing assumptions? How do the period's investment results impact your ability to achieve the yields assumed in pricing products? Can you continue to credit the rate you are crediting to your interest-sensitive products?

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How do results track versus GAAP assumptions? You want to do some additional analysis. For example, what does the asset/liability matching look like? What is the quality of the underlying investments? Are investment income targets being achieved by sacrificing quality? In that case, achieving budget or pricing or GAAP assumptions may be short-lived. So again, financial reporting must tell us how we are doing and why with respect to investments.

And finally, you want to look at taxes. Are premium taxes tracking as expected, or has there been a change in the geographical mix of the business? How are federal income taxes tracking with expectations?

We have to look at each of the areas -- sales, persistency, expenses, claims, investments, and taxes -- to get a feel on how we are doing and why. Once we do that we can try the other side of the coin. How can we do better? I have yet to see a company that is perfect, including the three that I ran. If that is a valid conclusion, then you know that every company can do better than it is currently doing.

The second purpose of financial reporting is to identify how can we do better. Again, looking at sources of profits, how can we increase sales profits? In addition to examining how we can get more sales by traditional methods, i.e., get more profitable production sources, run sales contests, etc., let's examine another approach. Can we increase sales margins by adding "power windows"? This phrase was coined by a group in Texas. Its analogy was a car dealer that makes a little bit of money selling cars, but makes a lot of money selling the extras to those cars, such as power windows. Can we do that in the insurance industry? Of course we can. We can add inflation riders, accidental death benefit, or disability to all the things we had all along. We can go to existing policyholders that have bought within the last 5 years and offer them double the coverage for double the premium. The answer to all these questions is obviously yes, yet very few companies make an effort to sell "power windows."

How can we do better with respect to persistency? Let me spend a minute on the "shoot versus fix" philosophy for agencies with poor persistency. We know we can improve overall results if we terminate agencies with poor persistency. That's the shoot part. How many successes have you seen in improving the

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persistency of any agency? That's the fix part. If your answer is the same as mine, I suggest that a shoot solution is more effective than a fix solution. Another myth you hear a lot about in the industry is that when there is a lapse problem, the solution is to upgrade your conservation efforts. You may see some temporary improvement. Over a longer period of time, however, the persistency of business is pretty well determined by how the sale was made. So if we look at how we can do better, we are basically looking at terminating agencies with poor persistency and providing incentives on persistency that attract quality agencies to our company.

What about claims? The first thing we have to do is determine how we can do better, determine what makes a trend. Many actuaries will argue that looking at claims over any short interval is not conclusive. I submit to you that it may take years to prove that mortality is good, but it only takes months to determine if mortality is really bad. The second thing I would like to suggest is the use of confidence limits in mortality studies. For most companies, ratios of actual to expected mortality are not statistically valid. However, for most companies, with the use of confidence limits, you can determine with 95 percent confidence the range of your ratios. If the ratios all lead to the same conclusion, you have the basis for making a decision.

Let's turn to investment income. There are only two areas where you can do better without help from the market. The first area is the quality of the investments. While you may lose more investment income if you upgrade in a high interest rate scenario than in a low interest rate scenario, the risk of lower quality investments is much greater when interest rates are high than when they are low. The second area is what people refer to as immunization. While I do not believe you can ever immunize a portfolio, I strongly believe you can sharply reduce your exposure, and that's part of the doing better part.

The last area is taxes. Since the new tax law, I feel as if everything I ever knew about the subject has become obsolete. But I believe that reducing taxes will always be an opportunity.

In summary, the purpose of financial reporting is to determine how we are doing and how can we do better.



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Let's turn now to the ground rules for financial reporting. I think that if you can follow these ground rules, financial reporting can be a tool in answering the how are we doing and how can we do better questions.

The first ground rule I would like to suggest is that you establish an equity line of business. This line will include investment income on past profits. We shouldn't blur the current picture by crediting our current product lines with investment income on past profits. The line should also include fixed expenses, and by fixed expenses I mean the expenses of keeping the door open and not functioning that product line. The example that Mr. Robertson used was a good one. Why should you charge to a product line the expenses of the Audit department that's making no money for the product line yet these are required expenses? My suggestion is that all of those expenses, as well as the income from capital and surplus, go into the equity line of business.

The next ground rule deals with investment income allocations. Everyone knows the theory that somehow the product line should be credited with investment income on cumulative cash flow less past profits. While this may be theoretically correct, in most companies it is very difficult to compute. From this theoretical approach, many companies jump to statutory reserves as the basis for allocating investment income. I would like to suggest the use of net GAAP liabilities. The new cases will have a negative net GAAP liability, hence will be allocated negative investment income.

I am astonished when I visit a company and find that a new product, on which we spend \$200 to get \$100 of premium, has positive investment income. I say, "How do you do that? I couldn't do that if it was my money." So my suggestion is to use net GAAP liabilities as a proxy for that. If you want to get fancy, you can try to come up with some kind of mechanism that simulates the dynamics produced by an investment year method approach.

The next set of ground rules deals with expense allocations. When we discussed the equity line of business, we touched on the fixed expenses. I would like to echo what Mr. Robertson said. There is no point in going to great pains to allocate expenses to profit centers and then having a number that the manager has no control over. If he really can't control the rent that you owe on the

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building, and nobody is going to sublet the space, why spend the time allocating who gets what portion of the rent space?

The direct expenses are fairly easy to allocate. The indirect expenses get a little complicated, but keeping track of activity tends to make it fairly easy. For example, data processing expenses to my mind have to be allocated back to the profit center.

The last key ground rule for financial reporting is that the information must be actionable. If you cannot act on the information you receive, you have what a former colleague of mine used to refer to as IBM data, interesting but meaningless. For the information to be actionable, one must think through what is a line of business.

Too often, companies create profit centers or reporting systems that follow the convention blank line breakdowns. To me, a line of business is a grouping of business that is actionable. For example, I would lump all discontinued lines of business with guaranteed premium rates into one category -- discontinued lines of business. While it's informative to see the results of these lines, what actions can I take to improve their future results?

I would group all similar products sold through similar distribution systems in a line of business.

In order to have actionable information produced, one examines GAAP assumptions. Have assumptions been tilted to bias the incidence of profits? In order for the information to be actionable, you must remove the impact of those biases.

The next information which must be actionable is persistency. As we discussed earlier, you want to look at persistency by product source, by product, and by product within production source. We also discussed claims earlier. The use of confidence limits can make data that otherwise would not be actionable become data that can be acted upon.

To act on expenses, you have to get the data broken down by cost center. It's one thing to know that salaries are over plan. It's another thing to know that

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salaries in department X are over budget. The latter is something you can act on; the former is not.

And finally, we have investment income. Is investment income over or under plan due to market conditions or because more of the funds were invested short than was assumed in the plan? The latter is actionable, the former is not. In order for financial reporting to make a contribution to end results, information must be actionable. There is really no point in spending the time preparing data if it ends up in a file.

MR. SOLOMON GOLDFINGER: Mr. Robertson, with regard to allocating expenses in a mutual company you said you might consider allocating all the expenses to all the profit centers. What is the reason?

MR. ROBERTSON: The problem is the expense allocation. You do expense allocations for several different things and you probably don't do the same allocation for different things. For example, we talked about not allocating all of our overhead expenses. That makes eminent sense for profit center reporting but it can get you in serious trouble for pricing if you don't have at least some mechanism for recovering those expenses either through additional revenue or through a second allocation process. Perhaps the same thing applies to mutual company profit center accounting. You have an obligation to maintain equity between classes of policyholders. That means that each class must make certain contributions to the company's overhead. So you do need a mechanism for getting those expenses into the appropriate operating areas, at least for the purpose of distribution of surplus. Perhaps the answer is the same answer I came to with pricing. You need a secondary or a different system for keeping track of the relative surplus contribution of various operating areas than you use for measuring the performance of a given business unit. You will create some confusion if you have different measures for different purposes. I have not thought of a solution for you. I am not sure I could if I were in your position.

MR. GOLDFINGER: Mr. Fafian, top executives frequently ask for information that would enable them to answer the questions you outlined. Very often the response is, we don't have information of that sort and you certainly can't get it out of our financial reporting system per se, if you take that in the narrow sense of bottom line reporting. To what extent do you find that the information

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to answer the questions of what financial reporting means to you is in fact available in your companies?

MR. FAFIAN: One of the reasons we sometimes feel information is not available is that we look for three decimal accurate answers. Very often, you can get to the same conclusion as long as you know the answer is somewhere between this value and that value. Generally I have found sufficient data is there.

MR. J. LYNN PEABODY: Mr. Robertson, could you discuss how you fit your data processing department into the profit center concept, and whether or not you try to allocate benefits from the data processing center to the various individual profit centers that are using those computer services?

MR. ROBERTSON: Data processing for the most part is a staff function. It carries many of the problems that are identified with staff functions in that there is a difference between the people providing the service and the people who are trying to determine the service level that is appropriate. Depending on the data processing function involved, and to some extent on the department involved, we benefit by a partial decentralization. For the larger departments, development is decentralized. Each major operating unit does have its own development staff and that at least gives them control over the level of new business development.

On the other hand, we get into short-term versus long-term problems here. I think we have been hurt as a company by overemphasizing the short-term benefits in the data processing area and have not put enough resources in longer term, the things that will pay off 2, 3, 4 or 5 years out. On the operations side, the processing side, we do not decentralize, except for our property casualty operations, which are separate. There we simply try to have a formula that charges so much for each unit of utilization whether it's each unit of CPU time or each unit of tape storage, or whatever the particular function is.

I am not very satisfied that this approach is doing a particularly good job in controlling costs. Perhaps the reason is that the people ordering the services and the people who understand what it takes in terms of resources are simply too far apart. It doesn't work as well as it might. The answer might be further decentralization, and to have a computer system that may have one CPU

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unit where information is being sent in and out in an area much closer to the operating unit.

The short answer is that we try to charge directly the cost of everything involved. We try to define unit costs. We try to make those known and encourage people to use them. It is of some value but not a lot.

MR. STEVEN MILLER: Mr. Fafian, you stated early in your presentation that a manager should be responsible for the use of capital, and later that investment income should be allocated using cash flow, implying that that manager is not given any capital to work with. Are these two views consistent?

MR. FAFIAN: If we look at the the whole cash flow notion, it says, where are your priorities? In Mr. Robertson's comments you can see the evolution at Lincoln. Whatever time frame he was talking about, capital really wasn't an issue. That's the environment I was accustomed to dealing with at US Life because we had a lot of capital, and at National Benefits we had very rich parents that were more than happy to put capital into financial services. When looking at a financial reporting system for a company, you have to deal with not only the needs of the company but the people that are involved in that company. If you have a fellow with one kind of background running the company, you probably don't want to get into it. If you have a fellow with a different type of background, you do want to get into it.

MR. ROBERTSON: Bringing capital into the equation is a major complicating factor. It's hard enough to understand earnings. Now you really have two variables to work with, and you need to understand the relationship between those two variables. The variable capital is something that you are not used to measuring. You get a very complicated process in trying to allocate it. On the other hand, we've discovered the payoff can be very large. We are several orders of magnitude more efficient in managing capital than we used to be.

People can become very creative in finding ways to limit the use of capital. You've got to be sure that their creativity is in the long run beneficial. One of the ways to reduce capital is to increase your leverage. If you're not careful, they will find ways of increasing the leverage that you can't even find. But it's a very powerful tool to put into place.

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MR. AL CHRISTENSEN: Mr. Robertson, I feel that a company needs to synthesize three sets of interests, those of owners, those of customers, and those of employees. Can you integrate the interests of employees and customers into an owner-oriented system of profit reporting, or do you need additional systems to reflect the interests of management?

MR. ROBERTSON: You're absolutely right. There is a lot of debate, however, in business circles as to the purpose of a for-profit corporation. You are tempted to come up with a simplistic answer, that it is to produce value for shareholders -- period. If you start there you can still develop a thesis that it is important to develop a company that is also producing benefits for customers and employees, or you will not be able to accomplish the first objective.

In many cases that general philosophical approach works well. I'm not completely comfortable with it because I think that it can lead you to some incorrect conclusions. We've got to realize that while the corporation is an entity that is created in order to create value for stockholders, who allows us to create the corporation? The corporation is a creation of law, of society, and therefore it will be allowed to exist only as long as it serves society. Now it serves society very well by efficiently managing economic resources. But if it manages those resources to the detriment of customers, employees, or any other interest group, the corporation is going to be under attack (and has been under attack) from society in general. Some of the worst damage to our economic system has been done when the corporation has been allowed to get out of control.

That's a philosophical answer, while you were looking for a system to measure what we are doing. I have no idea of how to do that. I think it takes well-educated and thoughtful managements supplemented by advice from boards and interest groups. We have just got to be sensitive. On the other hand, we still are in business to make profits for our shareholders.

MR. CHRISTENSEN: My other question has to do with your measurement of performance based on return on equity. Suppose the manager of your group health line came to you and said, "I have some figures here and I have done a few analyses and I think we should close down the group health line and open up a chain of Chinese restaurants." What would your response be?

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MR. ROBERTSON: That's an example of where the corporation has got to manage. We have to look at it as a strategic question, whether or not we want to be in the restaurant business.

MR. CHRISTENSEN: Perhaps the right comparison to be making is not one profit center against another, but rather each profit center against what the opportunities were for that particular line of business in the economy as a whole.

MR. ROBERTSON: Our group insurance operation has as its mission producing a satisfactory rate of return by providing group insurance and related employee benefits. If they want to change that mission, then they have got a very important strategic corporate decision that has to be addressed. There are constraints on how they can manage their businesses. We try to make them reasonably broad, but not that broad.

MR. JAMES J. AVERY, JR.: Mr. Robertson, you talked about purchased services or transfer pricing between service centers and the business units. Where do you believe the control lies on whether a business unit is able to independently procure services, even from an outside third party, as opposed to being a captive purchaser from one of the corporate areas?

MR. ROBERTSON: The answer I believe is, what produces the better result for the company as a whole? If in fact an outside vendor could deliver services less expensively than our own staff, then we ought to be buying those on the outside. If there is something wrong with our transfer pricing or our mechanism for charging, or if there is overhead that is being absorbed by buying on the inside that we would not save by cutting it out, then we would not allow them to do that. But we encourage the operating units at least to ask that question because very often by so doing they can uncover weaknesses in the management of our staff operations. It's the kind of creative tension that can be very helpful.

MR. AVERY: Mr. Robertson, you mentioned the need for a high degree of integrity required of the financial staff within a profit center. Could you expand on where you believe the control should be placed for judgment of the appropriateness of the assumptions used by this staff? An example of this would

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be the recent issue of additional reserves required for the AIDS risk, or the more common issue of loss recognition. Generally when the issue of loss recognition surfaces it is already evident that the original pricing assumptions contained in the GAAP reserves will not be met. The management of a business unit will generally have a plan by which they hope to recover any losses, thereby avoiding loss recognition. Where do you believe the control of passing judgment over the adequacy of the assumptions contained in the plan in order to avoid loss recognition lies?

MR. ROBERTSON: I'm responsible for determining our company's accounting policy. I include in that the kind of issues you are talking about, whether additional reserves are needed for unexpected contingencies or for new contingencies, and whether in fact it is appropriate to make a provision for certain future losses. There is a limit, of course. I don't get involved in setting property casualty claim reserves, but I do examine what they are doing and I expect them to tell me what they're doing and why. That's the kind of control we need to have. If they have a question as to which accounting policy we should be following, I expect to be involved.

Now our audit functions could be very helpful here, both the internal and the external ones. When you start talking about things like loss recognition, or additional reserves for contingencies, it may be that the operating unit is reluctant to bring that sort of thing to the attention of top management. I may not be knowledgeable enough and my staff may not be knowledgeable enough to unearth those kinds of questions. That is one of the things we rely very heavily on our outside audit firm to do for us. They know what the issues are. They know the questions to ask. It is not unusual for them to unearth a problem that we're not aware of.

MR. ROGER S. MOON: We've discussed the responsibilities of the operating unit with respect to expenses. To what degree is the management of a strategic business unit responsible for establishing investment policy, and to what degree is it responsible for the risk entailed in setting that policy and for the results achieved in terms of investment income?

MR. ROBERTSON: It is a shared responsibility in our company. We have a centralized investment function. I have difficulty seeing how it could be



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otherwise because it is very difficult to accumulate the kind of expertise you need to identify and manage investment portfolios without doing it on a corporate-wide basis. On the other hand, business units are being held accountable for the profitability of the products that they are writing. Furthermore, the investment strategies to be used with respect to the assets generated by a business unit depend considerably on the nature of the business being written.

We do have a corporate policy, to the extent that we can, to match our assets and liabilities, which means that the investment strategy must include strong contributions from the people that understand the liability structure of the business unit. Each major business unit has its own investment portfolio so that we don't have to allocate the investment income. Instead, we can directly credit it and can directly measure the distribution of the maturities of the investments and compare that to our perception of the distribution of the maturities of the liabilities.

But there is still a wide range of issues where neither the operating unit nor the investment operations can come up with the right answer. With respect to quality issues, we can get involved in some short-term and long-term disincentives. One way to increase investment income is to reduce quality. A business unit being evaluated on current profits has every incentive to reduce quality of investment. There has to be a system to control that. The investment people, on the other hand, tend to have incentives in the other direction. Their operations tend to be much easier the fewer investment problems that are unearthed. We have a corporate-wide investment counsel that tries to give some direction to issues like this and tries to evaluate quality.

With respect to a policy of matching assets and liabilities, you don't always know when you're matched. Even when you are, there are times when there is value in biasing that one way or another. We need to have mechanisms that allow us first of all to determine whether we are biasing it one way or another. Second, we need to determine what we want to do on a corporate-wide basis to make sure that the sum of all the parts produces a corporate-wide activity that makes some sense.

There are three parts to investment management. There are the people in the business unit who know their liabilities and are accountable for the profitability

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of the product. They are expected to make policy recommendations. There's the investment department. They are the people who go out and get the investments, evaluate them, manage them, and so on. Then there is the overall corporate management, which includes contributions from various sources. Let's try to make sure we have all these forces in balance, and that corporate-wide what we are doing makes sense -- that the sum of the whole is at least as great as the sum of the parts.

MR. HAROLD D. SINGH: Suppose a unit is on a functional basis. You have a retention of a million dollars. Then you break it up into eight profit center units. It's likely that any one of those units cannot support a million dollars. What are some solutions you suggest to handle that?

MR. ROBERTSON: One purpose of reinsurance is to give credibility, while protecting surplus, to the measure of financial performance. One solution is to have lower limits of retention for smaller business units. It is not always necessary to go outside to buy that reinsurance. You can do it internally as well. More often you can shortcut the process. Let's suppose that we decide the solution is internal reinsurance of some kind. We don't need to spend as much time agonizing over the proper price for that reinsurance as we would if we were dealing with somebody on the outside. We could come up with a transfer price that is at least some reasonable measure of the value of the reinsurance that is being purchased. Or you can do what amounts to the same thing: you can say that you are only going to count fluctuations up to a certain level. You in essence have put a stop-loss reinsurance on the performance of the operating unit. While you are not charging for it, that charge becomes in the nature of other unallocated expenses.

The fundamental thing is that if you get to a point where statistical fluctuations and experience are what's driving the financial performance of the unit, you are going to lose a lot of the value of those financial performance measures in motivating and measuring the performance of the business unit.

Mr. Fafian, you stated that financial reporting has two purposes: to determine how we are doing and how to do it better. I would add a third purpose: to determine what is it we are supposed to be doing. Your definition of financial reporting suggests that answer. Would you agree?

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MR. FAFIAN: Let's go back to the Chinese restaurant example. Financial reporting is part of an overall management system. If, as part of that management system, you don't have a well-defined mission for each of the other segments, then financial reporting by itself is not going to solve the problem. You go back to the question of what we should be measuring.

The mission for an entity is not measured necessarily in terms of pure bottom line. Staff functions are an example. When those of us in the 1960s tried to get into the mutual fund business, we weren't really looking so much at making money in the short haul, but rather we felt that it was necessary to retain our distribution systems. So sometimes the financial reporting measurement is something other than a bottom line. I think that ties in to what you said. It still is getting back to the basic questions of how do we do it and how can we do it better, whatever the measurement is.

