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The Integrated Advantage—Part II

Aligning Tasks to Gain Maximum Advantage

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Imagine you are a track coach. You attend a meet with your team and they begin the competition. There are no results announced or scores posted as the meet progresses. You are able to observe some of your athletes' performances and your team provides their impressions. At the end of the meet, the final score is posted and you discover that your team was beaten by the smallest of margins. What went wrong? What could the team have done differently? What have we learned that we can use in future meets? Very little.

This same situation sometimes occurs in companies. And it can be avoided. By integrating and aligning seemingly disparate activities, great gains ensue due to consistency of approach and economies of scale. This can occur at the personal level and at the organizational level. In the last issue of *The Stepping Stone*, we examined the benefits of linking personal goals, prioritization and performance management. In this second article, we will explore the benefits of aligning pricing, forecasting and financial reporting.

Corporate Alignment

Most managers have seen firsthand the effects of corporate misalignment at certain stages in their careers. Everyone knows that issues like these arise after results fall short of expectations. These postmortem analyses are frustrating for all involved parties as management sifts through the ruins of a bad quarter/month, trying to find the key information that explains what went wrong. Often, the true answer cannot be found because of limitations in data or the granularity of the available data. Let's use a simple example from statutory accounting: Suppose statutory profits fell in the most recent quarter—is that a good thing or a bad thing? If the company sold higher than expected volumes of a very profitable product, it could be a good thing. If its expenses were well above expectations, however, it could be a bad thing. In the end, the ability to distinguish the difference is paramount to a company's success and the success of its managers.

Most companies' accounting systems go beyond statutory to GAAP and EVA, adding complexities to the task of figuring out what is going on. Add the complexities of corporate structure and the difficulties in measuring things such as direct expenses and overhead and the potential for misinformation multiplies. Finally, I have seen companies where different software or different and incompatible versions of the same software are used throughout the company, further hindering explainability. What's an actuary to do? If you read my last article, you will probably surmise that the key lies in the time spent well in advance of the quarter/month end.

If we go back to the beginning, before anything is sold, a clear vision can be established. During the pricing process, the company decides what to sell. In the forecasting process (sometimes called budgeting), the financial expectations are determined. After products are launched, the financial reporting process provides the scorecard that tells what happened.

How do we go about modifying the system to work for us as managers and not against us?

The Process

Some important goals in pricing are to evaluate market opportunities, determine anticipated profit levels and predict the incidence of profits. This can be accomplished at many levels, thanks to the powerful software packages available. The simplest approach may be a financial spreadsheet or other policy year asset share model. While helpful in making a go/no-go decision on a product launch, this analysis falls well short of the level needed to lay out expectations for a given year.

Fortunately, more sophisticated analyses are within our grasp. First, we can build statutory income statements and balance sheets that detail the incidence of statutory profits on a calendar year basis since corporate life is measured in calendar years, not policy years. GAAP adjustments can be incorporated as well, providing meaningful insights into the most commonly used profitability measures. However, the real key to future explainability is the isolation of first year versus renewal results. In pricing, this information is often readily available.

Forecasting

If calendar year pricing models are available on the appropriate accounting basis, the forecasting process can begin. In most companies, there is an in-force block to be modeled in addition to new sales. It is beyond the scope of this article to describe the process in detail, but it is important to note that the models need to be built on a plan/issue year basis. Counter intuitively; this means that three sets of models are built: new sales, first year models for last year's sales and in-force models for last year's sales and years prior. Most of us forget the second set of models. Since production occurs throughout the year, some issue year results straddle two calendar years.

Financial Reporting

As actuaries, many of us focus the bulk of our attention to pricing and forecasting. Even financial reporting actuaries shy away from the reporting process, save for delivering actuarial figures (reserves, DAC, etc.) to the accounting department. Likewise, our accounting brethren do not spend significant time studying the actuarial models. This is the main reason for the disconnect between pricing, forecasting and reporting. It is also the most difficult situation to remedy.

The key lies in the general ledger (GL) system. If companies would create accounts in the GL to match the pricing and forecasting models, it would be possible to compare actual results to those anticipated in the models. At this point, there is still work to do, splitting data for the non-actuarial items, such as expenses, into plan/issue year categories.

Having done this, the above scenario changes dramatically. Variations from plan can be isolated to products and issue years because the scorecard matches the game.

Conclusion

The benefits of aligning pricing, forecasting and reporting are clear. Yet it is much more difficult to implement this type of alignment versus the personal alignment from the prior article. An individual can align goal-setting, prioritization and performance evaluation without much help from others. In the typical company setting, it takes many more resources to align pricing, forecasting and reporting. The costs are greater as are the management skills needed to succeed, but the benefits are also commensurate with the costs in the form of understandable results and corporate insights gained. This is truly a journey because so many areas are impacted and it's not likely that one individual controls all the needed resources. With proper vision and attitude, a company can embark on this journey with confidence that it will reap increasing benefits over time. In the words of the philosopher Loren Eiseley, "The journey is difficult, immense, at times impossible, yet that will not deter some of us from attempting it." ❑