Budgeting - Zurich

Zurich Insurance Group is a leading global provider of insurance services. Insurance is an extremely competitive market. One of the most useful financial tools is the budget. A budget is a business plan expressed in financial terms. Budgets can be drawn up for sales, costs or investment spending. A budget will include a degree of prediction of performance which is usually based on past data e.g. sales. Managers at all levels will have their own budget plans, designed to co-ordinate with and contribute to the overall plan or master budget. Budgets should be stretching but achievable. All budgets must be carefully monitored, reviewed and, if appropriate, re-assessed as internal factors (e.g. a major project costs significantly less or more than expected) and external factors (e.g. regulatory developments) change.

The process of budgeting requires managers to plan ahead, for example, to identify the resources required to meet targets. Insurance generally addresses medium- and long-term needs of customers. Decisions taken now are likely to have financial implications for many years to come. The budgeting process can be used for monitoring and control of financial performance. Managers need to investigate the difference or variance between budgeted and actual results. Where actual figures are worse than budgeted, these are called adverse variances. Adverse variances may suggest problems. Where budgets are not being met, action can be taken. Budget targets can be highly motivational and staff who meet or exceed budgeted targets may be rewarded with bonuses.

Effective budgeting is full of challenges. Whilst financial accounts relate to the past, budgets are about the future. All data is therefore planned rather than actual, probable rather than definite. Budgets are based on a number of assumptions. Some of these are explicit, such as what the cost of labour and raw materials will be or what market research results indicate about likely customer demand. Others are more implicit. A change in leadership in the sales team, a good relationship with a new supplier or changes in the organisation's external environment could all affect budget projections. Zurich may face unanticipated changes in legal or financial regulations or a change in market dynamics brought about by economic factors or the actions of competitors. An insurer needs to predict the risks its insurance policies protect against, both short term risks, such as floods and earthquakes and longer-term risks, such as mortality rates. Budgets may also cause conflict between departments. For example, the allocation of additional budget to sales and marketing could result in operational areas receiving a reduced budget.

Analysing budgeting data may uncover opportunities that would otherwise have remained hidden. Therefore budgets must be set using the best information available but have flexibility in order to respond to the changing business environment. Having established the core financial objectives, often referred to as key performance indicators, the strategies to achieve them can be set in one of two main ways. The budgeting process can be:

- 'top-down' - i.e. set by senior managers and directed downwards, often based on previous results
- ‘bottom-up’ - i.e. evolving upwards from middle managers, through the use of detailed analysis, for confirmation by senior management.

In practice, at Zurich there are elements of both approaches. Senior management undertakes the top down 'ambition setting'. This gives the strategic context. Managers then consider historical data, prevailing trends and any new drivers in order to formulate proposed budgets.

An alternative approach to incremental budgeting is zero-based budgeting. This means that each expenditure budget starts with a zero allocation each year. Managers must justify each element of the budget they propose. This has the advantage of making managers think proactively about what funds they need.

The first results against budget may show that the business is not exactly on target. The budget then becomes a ‘dashboard’ to assess all the factors and make the necessary changes to reach goals. Variance analysis is used to identify differences between budgeted and actual figures. This can be demonstrated using the illustrative expenditure budget for UK Life.

UK Life - Expense budget dashboard 2012 £m

FUNCTION	YEAR TO DATE (end April)			FULL YEAR OUTLOOK			
	Budget	Actual	% budget	Budget	Forecast	% budget	Trend
Sales	45	48	107	137	134	98	↑
Propositions	28	33	118	82	100	122	↓
Operations	73	64	88	229	212	93	↔
Finance	20	19	95	60	55	92	↔
IT	40	45	112	123	134	109	↑
Control function	10	8	80	30	23	77	↔
TOTAL	**216**	**217**	**101**	**661**	**658**	**99**	↑

KEY

	Worse than a 10% adverse variance (i.e. >110% of an expense budget or <90% of a revenue budget)
	Less than 10% adverse variance
	Favourable variance
↑	Improving trend
↔	Stable trend
↓	Worsening trend

Results better than or on budget are ‘green’ and represent no immediate problem. They may be worth investigation to understand new practices or to exploit new opportunities. Results that are only mildly outside expectations are 'amber'. These may need attention particularly if there is a worsening trend. Finally, there are the adverse (‘red’) results. Red areas demand immediate investigation and remedial action to bring performance back to budget.

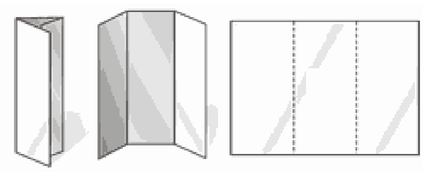
All results should be investigated based on the level of risk each deviation poses to meeting the overall business goals, but priority should be given to red areas.

Questions

1. Define the term ‘budget’.
2. Describe variance analysis.
3. Explain the advantages of using budgets.
4. Analyse the difficulties Zurich faces when setting budgets.

Task

Create a leaflet about budgeting aimed at providing information for a new entrepreneur. If a two-fold leaflet is created, one section each can be used for the front cover, an explanation of budgeting and budget setting, benefits of budgeting, drawbacks of budgeting and an explanation of variance analysis.



What have you learned?

Write 5 questions about budgeting. Swap your questions with a partner and answer each other’s questions. For one of the questions you should provide some budgeted and actual figures for revenue, expenditure and profit, and get your partner to work out the variances.