9 Insurance Company Costs and Cost Allocation

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9.1 INSURANCE COMPANY COSTS AND THE NEED FOR COST ALLOCATION

Most textbooks dealing with costing consider the example of a manufacturing company. The company buys raw materials or components, incurs costs in adding value to them, and sells the resulting products at a price, which, at least in the long run, must cover all costs plus profit margin.

There are many parallels between the manufacturing company's costs and those of an insurance company, but of course an insurance company does not incur raw material costs as such. Instead, the insurer's revenue - its premium income and investment income - must cover three cost components, plus profit and tax. These components are:

- claims (typically 65–80 per cent of premiums)
- commissions (typically 14–19 per cent of premiums)
- management expenses (typically 12–18 per cent of premiums)

The figures in brackets indicate the approximate percentages typical of a large insurance company's non-life business. The claims percentages include claims-handling expenses. All figures relate to gross written premiums.

If an insurance company is to remain competitive, its management must be concerned with all of these cost components. However, while claims and commission will together account for the greater part of the average insurer's costs, they will normally be incurred in respect of identifiable, individual policies. Problems of allocation as such do not arise. It is the ways in which management costs are dealt with which are considered in this chapter. But why should insurance companies take so much trouble to analyse and allocate costs? Clearly costs in general must be kept as low as possible consistent with running the business effectively and providing a competitive service to the policyholder. Why try to determine how much of a particular expense - the chief executive's salary, for example - relates to a particular class of business, or branch office, or even individual policy?

In the case of a small business, producing a single product, cost control may be straightforward enough. The owner knows what costs are incurred.
and why. He is in a position to judge what costs are higher than they need be and to take steps to reduce them. He knows that all costs must be covered by sale of his product and that his prices must take this into account.

Insurance companies, though, are not small businesses. They are frequently very large ones. They usually have an extensive range of different products, often sold through different divisions of the company, each with its own cost structure. And they spend large sums of money daily on such diverse things as salaries and telephone bills, cars and computer stationery. Responsibility for controlling costs, for setting the prices which must cover these costs and for achieving results, does not and cannot rest with one man. The management of a large company requires different levels of decision-making and accountability to be delegated down throughout the organisation. So, if this diversity of expenditure is to be controlled, and ultimately reflected in the price of policies, careful allocation of costs is essential.

In fact, allocation of costs is necessary for reasons other than cost control and pricing. Much of the effective management of an insurance company depends on knowing what costs 'belong' where. Cost allocation is necessary for:

- Company accounts – the retrospective records of the company’s financial results, produced each year for shareholders and others;
- Returns to the supervisory authority – the statutory returns which the company must make for the statutory supervision of its business;
- Management control;
- Management decision-making.

We will examine the importance of insurance company costs under each of these headings, but first we need to consider just what an insurance company's costs are made up of.

9.2 CLASSIFICATION OF COSTS

By item purchased

Claims and commission apart, what does an insurance company spend its money on? The most obvious item of management expenses is staff salaries, which are usually the largest single component of most insurer’s management expenses, representing typically 8–12 per cent of gross written premiums for a large non-life insurer. But there are many other types of expenditure, and some of the most important are shown in Table 9.1. Individually, most of these will normally represent less than one per cent of