

Cost Management Opportunities

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A3.01 INTRODUCTION

Cost Management information is an important source of business management information for the service industries. It can be used to improve decision making and business analysis (strategic cost management) and can also be an effective management tool to control operations (operational cost management). The discussion of these, as well as other uses, are included in several case studies meant to illustrate the benefits, clarify the differences between strategic and operational cost management, and provide a “how-to snapshot” for the reader.

[1] Primary Industry Differences between Services and Manufacturing

One of the primary economic differences between manufacturing and service organizations is how the customer derives value. In manufacturing organizations, the focus is on delivering value in a tangible product coupled with service attributes that meet customer needs, such as quality, timely delivery, technical support, etc. In service organizations, the focus is on fulfilling customer needs and expectations through the performance of one or several business processes. Typically, these business processes are experienced directly by customers and often become the source of competitive differentiation such as time, quality, service responsiveness, and cost. As a result, the ability to measure the cost of performing activities and how these activity costs are associated to the service and customer can be an important factor in defining strategy and in achieving sustainable competitive advantage.

One of the specific accounting differences between manufacturing and service organizations is that the cost to manufacture a product is cumulative and capitalized until sold to the customer. With service companies, however, cost is expensed as incurred; consequently, if the services available (activity capacity) are not productively utilized, they cannot be “saved for another day.”

Service organizations recognize the “use it or lose it” characteristics of activity capacity, and therefore devise management practices and measurements to plan and control their activities and services. In today's cost management vernacular, managing activities is referred to as *activity-based management* and measuring activities is referred to as *performance measurement*. Taken together as an integrated management practice, it is referred to as performance management.

[2] The Activity-Based Costing Methodology

Recently, companies within various segments of the service industries have begun to use a costing methodology entitled activity-based costing (ABC) to generate cost information. This information can be used in a variety of applications such as pricing, profit analysis, cost

reduction, and investment analysis, just to name a few. Basically, in the ABC methodology, activities consume resources, performing activities creates services, and customers consume varying levels or degrees of services. (See Chapter A1 for more information.)

The reason ABC has become an effective costing method is its fundamental concept that decisions made by an organization cause activities to be performed which consume resources. The more diverse and complex a product or process, the greater the number and level of effort required to perform these activities and the more resources will be consumed. ABC provides the mechanism to link resources consumed to decisions made.

A3.02 TODAY'S FINANCIAL AND COST INFORMATION ENVIRONMENT

For many service companies, accounting information used for financial and regulatory reporting is also used to support strategic decisions. Unfortunately, many managers who must rely upon traditional accounting information for decision making find the information both incomplete and distorted. The information is incomplete because it includes only the direct cost to acquire the customer or provide the service. It is distorted because the cost information includes an assignment of overhead that was allocated using volume-based measures, such as sales dollars. Sales units often do not reflect the underlying economics of the business. Much has been written regarding how diversity and complexity of operating activities drive the levels of cost. Therefore, when volume-based measures are used exclusively to allocate cost, the costing information is usually distorted.

For example, within many organizations, direct customer investments (i.e., terms and pricing, service levels, marketing, communications and retention spending) and indirect investments (i.e., customer service systems, billing and collection procedures, technical support and training) typically are not recorded as customer-specific costs. As a result, an organization's ability to evaluate customer profitability is limited unless it properly assigns these costs to the customer. Similar to companies that manufacture products, service companies have found that higher revenue producing customers and segments are not necessarily the ones that consume the most customer service, technical support, and marketing efforts. However, these customers are often assigned a higher share of these allocated costs. Consequently, profit margins on these customers are inaccurately reported; as a result, inappropriate business strategies may be pursued to correct the perceived "profit problem" for these customers or segments.

A3.03 USING COST INFORMATION IN THE SERVICE INDUSTRIES

Service industry companies often undertake special costing projects to help managers capture relevant cost information. Once these costing projects are completed, managers can focus their attention on using the information to support key decisions. The critical question is: How do we use the results of the costing analysis to improve financial and operating performance? Obviously, financial performance, will improve as a result of reduced costs and/or increased revenues. More specifically, costing information can be used strategically in the following applications:

1. Strategic profit analysis

2. Creating a customer based strategy
3. Costing operational changes
4. Simulating process improvement
5. Justifying technology investments
6. Linking to other improvement initiatives

[1] Strategic Profit Analysis

The most prevalent use of costing information by service industry companies is to help support decisions about services offered and about markets and customers served. Costing information enables management to identify profitable business segments and services. It is common, for instance, to discover a handful of services that cost more than their selling price or customers for whom the cost to serve exceeds their revenues. This allows management to answer questions and estimate the impact on its financial performance. Such questions may include the following:

- Can we stop offering this service to this customer or segment?
- Can we redefine how we efficiently deliver this service to customers or segments?
- Can we change the selling price?
- Can we reduce non-value-added costs from our services?

[2] Undertaking a Customer-Based Strategy

Many service companies are applying strategic cost management techniques to provide actionable information for marketers and operating managers. They have found that to develop a successful customer-focused business strategy that will maximize the value earned from each customer relationship, the financial value of the entire relationship needs to be accurately measured. Companies must understand the operational impact (activity capacity utilization and departmental spending) driven by customer behaviors. Thus, when customers pay late due to inflexible billing systems, call customer service centers because they do not understand a bill, or become confused with a new marketing offer, significant resources are consumed to correct the situation with limited financial returns. With relevant and insightful cost information, management will have the fact base to make meaningful marketing and business strategy decisions.

The customer profitability bar is an analytical tool to support key decisions. This tool balances the customer investment (activities, policies, etc.) and the current revenue generated by segment. Thus, by analyzing improvement opportunities for both revenue and cost, the company can maximize its return on investment (ROI) for each customer or segment.

[3] Costing Operational Changes

Costing information can be used to help a company model its operations, analyze proposed changes, and strengthen its basis for operational accountability. Within service industries, many companies are using ABC results to demonstrate the effect of process redesign and its impact on reducing cost. The operational savings attributable to these continuous improvement programs can now be measured and used to effectively manage the process as well as justify investments

in new services or technologies. For example, one firm reduced price to certain customers based on their analysis of non-value-added cost attributable to poor quality. In this case, the major driver of poor quality was data received from customers, which caused many unnecessary tasks to be performed (checking, correcting, re-entering data, etc.). An ABC analysis quantified the cost of these unnecessary/wasteful tasks and enabled the firm to offer price reductions to those customers who provided error-free data. These price reductions were more than offset by the reduced cost that resulted from eliminating these error detection and correction activities. With more and more service companies discovering the power of e-commerce, the opportunity to receive error-free data is significant and therefore, activities related to correcting errors can be significantly reduced or eliminated.

[4] Simulating Process Improvements

A cellular telephone provider used cost information to simulate the effect of process changes within its customer service organization. The company used ABC to document the “as-is” process and develop an economic model of this process. Proposed changes to the process were then incorporated to create the “could be” model. The model was then used to simulate the financial effects of proposed improvements.

[5] Justifying Technology Investments

A financial services processing center had been frustrated by its inability to meet return on investment thresholds in order to acquire new equipment needed to meet strategic goals. By using ABC to model its cost of (a) changing the process; (b) eliminating the causes of bottlenecks; and (c) reducing other non-value-added costs, the company was able to develop a framework for evaluating and prioritizing the relative returns from alternative technology solutions.

[6] Linking to Other Improvement Initiatives

One of the most important uses of cost information is the focus it can provide to continuous improvement programs. Strategic cost analysis, especially when coupled with business process analysis and cost driver identification, can help set priorities and monitor the progress of improvement efforts. By summarizing activity cost with the same cost drivers, managers can more easily address the operational issues that are most important for the company.

A3.04 CASE STUDIES

[1] Case 1: Analyzing Cost to Serve

A company with over 100,000 defined customers throughout the United States, wanted to develop new strategies about its markets and services and evaluate its whole approach to marketing and servicing customers. The company was concerned not so much with the profitability of individual products or services but rather with determining which customer segments should be targeted and what levels of services should be offered to maximize overall profitability. It also wanted to understand which aspects of its current organization and

infrastructure would most efficiently support any major change in its customer-based strategy. In addition, the company had experienced a high level of turnover among sales and service representatives and wanted to better understand its impact on customer segment profitability. The company chose to use ABC to analyze its costs and relative profitability of the customer segments it served because ABC provided an objective, analytical framework for management decisions. This choice required several important decisions to create the appropriate costing information architecture.

[a] Defining Cost Objects

Cost objects were defined as segments of customers, with each customer segment defined along the following three dimensions:

1. *Sales level* corresponded to annual customer revenues. Revenues provide the front end for profitability measurement.
2. *Service level* differed significantly from one customer to another. For some customers, the sales representative simply visited the customer on a regular schedule; during those visits, the customer would order items as needed. In other cases, the sales representative interacted on a more formal level, working through purchasing department buyers or engineering personnel. Higher levels of service included the sales representative physically restocking the inventory in the customer's display units and offering product demonstrations and collaborative problem solving services with the customer. Four levels of service categories were defined, and each customer was classified into one of the four categories.
3. *Industry group* identified the major industry characteristics in which their customers operated.

Thus, each customer segment was identified as a unique combination of sales level, service level, and industry characteristics.

To gain further insight into the impact of the turnover sales and service representatives on these customer segments, the following issues were reviewed:

- The relationship between sales/service representative turnover and customer profitability and retention
- The costs to recruit and train new sales/service representatives
- The relative profitability of new and veteran representatives
- The costs associated with a new representative becoming a veteran representative

[b] The ABC Approach

Once these definitions were complete, the analytical work of the project was to assign revenues and costs that were within the project scope into the newly defined customer segments. The basic logic for the analysis was to link the cost from their general ledger into activity cost pools and then from activity cost pools to the customer segments.

[c] Identifying Activities and Customer Segments Served

The team defined two broad categories of activities: (1) business-sustaining and (2) customer-sustaining. Specific activities and other attributes of management interest were assigned to each category.

The customer-sustaining category included all sales/service representative activities:

- Develop new customers
- Travel and waiting
- Face-to-face selling
- Replenish stock
- Problem solving during sales call
- Order writing
- Customer training

The business-sustaining category included all order processing and collection activities:

- Customer order entry
- Accounts receivable posting, lockbox
- Accounts receivable posting, nonlockbox
- Collections, internal
- Collections, outside agency
- Credit analysis, new customers
- Credit analysis, existing customers

[d] Identifying Drivers and Capturing Data

The organization had over 500 sales and service representatives. To estimate the relative effort required to perform different activities a statistical sample of representatives was selected to participate in a detailed survey. Each representative in the sample was asked to estimate the percentage of time spent in each predefined activity over a typical month. In addition, each was asked to maintain a detailed record by customer and by activity for a period of two weeks. Sales managers were asked to complete a similar survey, with special emphasis on the support required by new representatives, and veteran representatives. The results of the sample were used to extrapolate the activities and time spent for the entire population.

In other cases, existing data was available for other activity drivers:

- Customer order entry: number of customer order line items, by customer segment
- Accounts receivable posting, lockbox: direct charges made by the bank for lockbox processing of accounts receivable
- Collections, internal: number of “accounts” in “collection status” by segment
- Customer support: number of calls taken by segment

[e] Impact of Findings

Once the project team completed the ABC model, the results were used to develop new strategies for the company, including the following:

- Accounts with small sales volume were highly unprofitable at every service level and in every industry. The business strategy was revised to significantly de-emphasize all accounts that had only small sales volume potential.
- Accounts with high sales volume were quite profitable, even though there was much diversity in the levels of service provided to the customers. The current strategy of diversity in service levels seemed to be effective, and no change was made to the form or the pricing of those different service levels.
- Certain industries were only marginally profitable. After analyzing the composition of activities required to serve these segments, the new strategy emphasized ways to make these segments more cost-efficient.
- The executives' concern about the impact of new representatives was confirmed in the analysis. In fact, the impact was much more severe than originally estimated. The strategy revision included major new programs to achieve the following:
 - Increase retention rate for sales and service representatives
 - Improve the hiring and training process for new representatives
 - Provide greater incentive to penetrate highly profitable market segments
 - Re-engineer the sales and customer service business processes to improve quality and reduce costs

[2] Case 2: Reducing Costs and Improving Service Levels

This company provides full service administrative support in processing corporate 401(k) contributions, participant withdrawals, and other related transactions. The company wanted to understand why sales growth and costs were moving in tandem (i.e., increasing at a similar rate). It was widely accepted within the management group that core transaction processing was the primary output and managing excess activity capacity was the driving force for effective productivity. The organization expected to achieve economies of scale with the addition of several large accounts, but each new account seemed to add incremental costs and people. In addition, customer service levels were deteriorating in spite of large investments in training and information technology.

The project team set out to develop and implement a sustainable cost management system which would achieve four primary objectives:

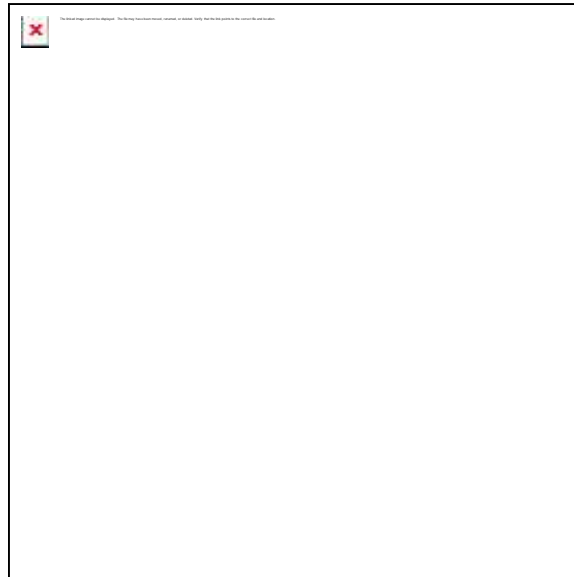
- Highlight high cost activities
- Identify non-value-added costs
- Provide data for marketing to improve customer service levels
- Provide analytical support for re-engineering and information technology investments

The flow of costs went from the general ledger (GL) into either a transaction processing pool or directly to an activity pool via a resource driver (Figure A3-1). Examples of resource drivers include square footage, CPU time, and phone usage. The use of traditional standard cost

accounting techniques was extremely valuable, as the core transaction processing resembled the attributes of a manufacturing shop floor. Standard minutes for each task were computed and then rolled up to the activity level. A cost per minute was computed (including occupancy and systems costs) and the cost of all types of transaction processing activities was calculated. The driver quantities were available from existing transaction processing systems; thus, activity costs for transaction processes were reliably computed.

Figure A3-1.

Flow of Costs Through Activities to Customers



[a] Obtaining the Data

Data was collected in the following areas:

- Time estimates for activities were conducted at all processing centers. Issues to address were the diverse methods the customer service personnel utilized for accomplishing the same task. The ABC team conducted facilitated sessions with several account teams and developed a “standard” method and time to process all transactions. The complexity variation within each type of transaction was accounted for by identifying additional tasks, along with time estimates of each task.
- Driver volumes were obtained by systems generated reports (call center and core transaction systems) as well as estimates of volume such as the number of payroll tapes updated and number of management reports issued to the client.
- An account manager survey was used to identify the non-transaction time spent. To facilitate this, an activity dictionary was created with the assistance of key operations personnel. Then a survey instrument was developed to collect the information. This survey was conducted over a one-month period, and the ABC team conducted a number

of sessions to gain consensus on the time as well as the definition of activities and how to drive them to customers (Figure A3-2).

Figure A3-2.

Cost Summary Using ABC Expenses (in thousands of dollars)

Major Business Process	Transaction Related	Non-Transaction Related	Total Costs	% of Costs
Withdrawals of assets	8,795	187	8,981	24%
Addition of Assets	3,373	150	3,523	9%
Movement of Assets	2,747	67	2,814	8%

Client Support	8,154	6,466	14,620	39%
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New Business Development	0	1,525	1,525	4%
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Company Sustaining	0	6,185	6,185	16%
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Total \$	23,069	14,580	37,649	
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Total %	61%	39%		

[b] Project Results

Analysis revealed the following findings:

- The surprise to management was that transaction-processing time accounted for only 60 percent of the customer service representative's day. Prior to the study, management believed that over 90 percent of the time spent for these people was transaction related.

- Almost one quarter of the organization's resources (24 percent) were dedicated to giving funds back to customers that were under the management of the investment company. The annual amount of assets being withdrawn was in the hundreds of millions of dollars. In contrast, only 4 percent of the organization was focused on expanding the depth of customer relationships. As a result of the study, customer service representatives were trained and motivated to cross-sell and advise participants of the full range of services available, thereby turning passive order processors into proactive revenue generators.
- On a more tactical level, but just as significant, the quality of the customer data was a major cost driver in the organization. For example, customers that provided complete information on new employees had a significantly lower cost to serve than customers that did not. Error correction, expediting, and account reconciliation became the number one driver of costs. By working with the customers to improve the quality of their data, prices could be lowered, making a win-win situation for the company as well as the customer. By removing these non-value-added activities, an additional 30 percent activity capacity could be obtained.
- Client support, primarily answering balance and inquiry questions as well as providing overnight delivery of routine documents, accounted for \$7 million annually. Programs were put in place to reduce or eliminate these expenses.
- Information technology investments were redirected to better serve the customer directly. The ABC analysis provided management with the insight to cost opportunities as well as the confidence to rely upon realistic payback of re-engineering initiatives. For example, computer telephony integration (CTI) was implemented to better assist participants in routine inquiries as well as to provide for automated transaction processing, such as movement of assets between funds.

A3.05 CONCLUSION

The benefits of strategic cost management and its use as a decision support and business analysis tool have caught the attention of a wide group of practitioners: management accountants, operations managers, and marketing managers alike. Through costing methodologies like ABC, when used with process analysis, service companies are finally able to see the dynamics of their costs and the impact that decisions that drive these costs have on their operations and profitability. Even more important, managers are able to structure action programs internally and with customers to better manage these costs as well as support the company's goals in improving quality, customer satisfaction, and operation speed and flexibility.