



ABC ANALYSIS

Leveraging Activity-Based Costing for Smarter Decision-Making in Lending Operations

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SUMMARY

Today's competitive environment compels lenders to find ways to optimize their spending while efficiently delivering services that enhance the client experience. To achieve this objective, lenders need to improve their understanding of how even small obstacles in their daily workflow can drive up costs. Based on our deep experience with several leading lenders, this paper sets out to address principles that are being followed as they seek to maximize economic value.

Many organizations do not have a full picture of where their money goes. Although it is easy to identify and define payroll expenses, lenders rarely take the next step of identifying the underlying granular time required for specific tasks by job role.

Mapping human capital spend to core processes, activities, and tasks can deliver a competitive advantage for those willing to invest the time in some basic analysis.

WHAT IS ABC?

Activity-Based Costing, also known as ABC, is a method of assigning costs to everyday activities within your organization. This can include processes, products, services, customers, and lines of daily business. ABC is based on the idea that the efforts required to produce products and services can be quantified and assigned to that product or service. Much like a Bill of Materials, services are delivered through an implicit “recipe” of components that are required to deliver the service to clients. ABC analysis transforms that recipe into a quantified, explicit view that enables better-informed management decisions.

HOW WAS ABC CREATED?

Frederick Winslow Taylor was an American mechanical engineer and one of the first “management consultants”. “Taylor sought to increase industrial efficiency and was one of the intellectual leaders of the Efficiency Movement in the United States.” Taylor memorialized his efficiency techniques, ideas and their benefits in his 1911 masterpiece, *The Principles of Scientific Management*. In early 2001, Fellows of the Academy of Management voted Taylor’s work as one of the most influential management books of the twentieth century. Today, Taylor’s book is still regarded as a leading source on the topic.

Taylor's scientific management "consisted of four methods:"

1. Replace rule-of-thumb work methods with methods based on a scientific study of the tasks.
2. Scientifically select, train, and develop each employee rather than passively leaving them to train themselves.
3. Provide "Detailed instruction and supervision of each worker in the performance of that worker's discrete task" (Montgomery 1997: 250).
4. Divide work nearly equally between managers and workers, so that the managers apply scientific management principles to planning the work and the workers actually perform the tasks.

By outlining your costs, you can identify, improve, or divest those services that are unprofitable, inefficient, or performing poorly.

The basis of ABC is that cost is consumed, and that "consumption can be managed." ABC provides a robust way for lenders "to create a foundation for cost accounting, chargebacks (if they occur), and performance management."

VISUAL REPRESENTATION OF ACTIVITY-BASED COSTING WORKFLOW

- The left column showcases the business questions addressed.
- The middle column showcases a visual representation of ABC implementation.
- The column on the right identifies the common on ABC terminology used to describe the data collected.

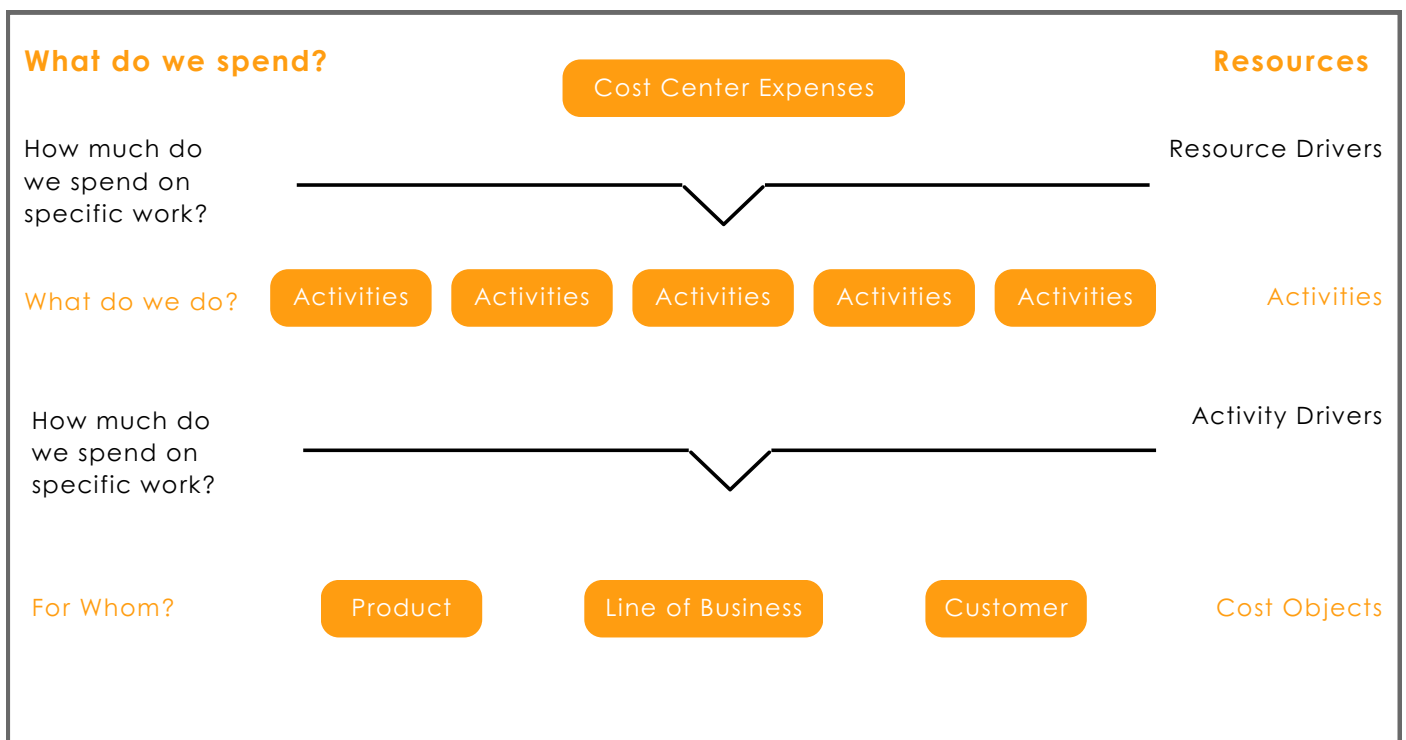


Figure 1 - Basic ABC Flow and Terminology

ABC TERMINOLOGY DEFINITION

Understanding the terminology associated with ABC can “make managing expectations and goals easier. Some examples of resources that can be impacted by understanding ABC terminology include personnel, equipment, third-party contracts, and facilities.”

Resource Cost Pools:

Are groupings of resources that are consumed in the performance of daily activities. An example of three resource cost pools for an organization’s labor could include onsite employees, contract labor, IT and accounting support, and others.

Resource Drivers:

Measure the number of resources consumed by a single activity. Resource drivers are different for each of the resource cost pools they impact. When you identify that the resource drivers for the resource cost pools are the same, then you have identified an opportunity to consolidate those resource cost pools.

Processes:

Are groups of related activities performed to achieve a specific objective in your organization. These processes can cross over from department to department.”

Activities:

Are what the people and systems are doing in an organization. Each activity someone performs consumes resources and produces an output. Just remember that activity names will always begin with a verb.” Examples of lender activities often include “Set Up New Account,” “Request Financial Statements,” and “Train Personnel.”

Tasks:

Are the parts of an activity that tell us how operations are performed within an organization. Processes, events, and tasks all represent the logical business process model.”

Activity Drivers:

Are simple measurements of the frequency and intensity of the demand placed on an activity by cost objects. They are similar to resource drivers in that, if the drivers for multiple activities are shared, there is an opportunity to consolidate activities.”

Cost Objects:

Represent everything that benefits from activities. Typically the products, services, and customers are the main cost objects for a lender.”

UNDERSTANDING ABC VS. TRADITIONAL COSTING

Traditional methods “take one pool of a company’s total overhead costs to allocate universally to all products and services. Using traditional Costing, the costs are allocated based upon the direct composition of the product. In a banking environment, traditional cost analysis is often used to assess the company as a whole, as well as specific departments or geographical regions.”

Conversely, ABC will identify all of the specific activities required to deliver each product.

The fundamental difference between **Traditional Costing** and ABC is that “ABC methods expand on the total number of indirect cost pools applied to specific products or processes, providing a much richer context for management decisions.”

THE PROS AND CONS OF TRADITIONAL COSTING

As with all processes, there are pros and cons to each method.

Traditional Costing is “superior when the overhead of a company is low compared to the direct costs of production. Reasonably accurate cost figures can be created when the production volume is large, and the changes in all overhead expenses do not create substantial differences when calculating the costs of production. Traditional Costing methods are inexpensive to implement for most organizations.”

Lenders often use **Traditional Costing** for external reports that are shared with outsiders because they are simpler and easier to understand. The downside is that Traditional Costing does not give managers an accurate picture of product costs. This is because “the application of overhead burden rates may be arbitrary or applied equally to the costs of all the products that are offered by an organization.” They may also be subject to internal politics, e.g. transfer pricing. This means that costs may not be correctly allocated to the specific products that actually consume the overhead activities noted.

THE PROS AND CONS OF ACTIVITY-BASED COSTING

Activity-Based Costing “will identify all of the specific overhead operations related to each product. It provides a stronger analytical basis by tracking what your organization’s human beings are actually doing to serve your clients.”

For managers to maximize shareholder value, they need a method to determine which services are profitable and which are not. ABC is the most precise form of costing, but it is also the most challenging and costly to implement.

Since banks require significant overhead investment to deliver core services, ABC represents an opportunity for lenders to drill into cost pools with much greater specificity and clarity. This is why dependence on the **Traditional Costing** method, as the only method, is dangerous for banks: it leaves major unanswered questions around how much precious capital is being spent, on which activities.

SERVICE ORGANIZATION EXAMPLE OF ABC

Here is a great example: “Imagine you are the Chief Financial Officer (CFO) of American Star Bank. You wish to implement an activity-based costing system so you can better evaluate the cost of various loan products you offer, such as auto loans, home equity loans, and business loans. You would begin by using the five steps of the ABC process.”

STEP 1.

IDENTIFY ALL COSTLY ACTIVITIES

Processing a loan request can include activities such as meeting with customers, reviewing applications, analyzing financial statements, and running credit reports.

STEP 2.

ASSIGN ANY OVERHEAD COSTS ASSOCIATED WITH ALL ACTIVITIES IDENTIFIED IN STEP 1

Let’s take the costs assigned to the activity of reviewing customer applications. “It includes items such as wages of those team members reviewing applications, the depreciation of the computer equipment used to review online applications, and supplies needed for the review process such as pens or software.”

STEP 3.

IDENTIFY THE COST DRIVER(S) FOR EACH ACTIVITY

<u>Activity Noted</u>	<u>Cost Driver for Activity</u>
Meet with customers	Preparation for meeting. Time spent on meeting.
Review applications	# of applications reviewed. # of pages reviewed.
Analyze financials	# of businesses and personal entities involved. # of financial statements required per policy.
Run credit reports	# of credit reports that must be run per entity, per loan.

STEP 4.

CALCULATE YOUR PREDETERMINED OVERHEAD RATE FOR EACH ACTIVITY

Processing a loan request can include activities such as meeting with customers, reviewing applications, analyzing financial statements, and running credit reports.

STEP 5.

ALLOCATE ALL OVERHEAD COSTS TO PRODUCTS

Overhead is allocated, or applied, to products based on the “use” of each activity’s cost driver. When a loan officer reviews five business loan applications, an amount equal to the rate per application reviewed times the five applications is allocated to the Commercial Loans product.

ABC RESULTS

Activity-Based Costing has been used for decades because it allows for sustained improvement of shareholder value through improved cash flow. As a lender, it is often easy to use Net Interest Margin plus Fee Income as a “success” scorecard. The idea of creating a new method of cost analysis in a highly regulated environment can seem daunting. However, even a basic implementation of ABC can arm managers with a quantitative basis to decide whether to reallocate tasks amongst roles, evaluate technology providers, and even whether to promote or terminate specific employees.

ABC can quickly create a picture of where your money is going. It can also show you where time is being wasted and where process bottlenecks are being created. By more specifically analyzing your costs, you can identify, improve, or divest those services that are unprofitable, inefficient, or that are poorly performing.

Imagine you are leading a local commercial lending group comprised of three production teams, each with a Relationship Manager, an Underwriter, and a Closer. If the process for underwriting new loan requests takes one of your teams one day to complete but the other two teams require two days per deal, the activities of each person within each team can be tracked to determine why there is such a disparity in efficiency.

Although ABC might be construed as “financial micromanagement” in the preceding example, knowing why that extra day is required represents significant intelligence for the organization.

This may seem subjective or insignificant for a group of ten bankers, especially if your lending group maintains excellent relationships in the local market. Very likely the team will enjoy career success, enviable stature in the community and profitability for the bank. However, when we apply this same methodology across a team of 100 or 1000, there is clearly an incredible opportunity for profitability and competitive position for the entire company.

For example, here is how ABC analysis enabled a commercial lending team to double their production within a \$6 billion regional bank:

“Prior to Cirrus, our packaging/closing team spent an average of 1-hour creating checklists and sending them off to the client, 6 hours managing the checklists and updating them as the deal progressed, and 9 hours renaming files to our standard. After Cirrus, this was reduced to about 45 minutes creating a checklist and sending it off to the client, and < 1 hour managing the checklist and updating them as the deal progressed, and no time spent renaming the file to our standard. Savings: ~15 hours per file.”

- Mark Abell, NBH Bank

INTRODUCING ABC TO YOUR ORGANIZATION

Organizations may experience initial resistance, from account managers to senior managers to entire departments, when ABC is implemented. “This may be due to fear that ABC will change the existing power structure of the organization and make some members of the team obsolete. Some may feel threatened because ABC naturally reveals highly inefficient practices that are often hidden by the traditional cost-accounting systems. Some may resist this change simply because it is new. Finally, some may fear the amount of work that will be needed to set up and refine systems initially.”

It is common that employees will question why the organization needs to change at all. Many employees may also fear that such a comprehensive system will eliminate jobs.

To best mitigate a wide variety of emotions that are often tied to change, it is essential that ABC is introduced in layers. This allows for acceptance from the “top-down” and creates a more synergistic approach to revitalizing how data and processes are measured and constructed.

When ABC is woven into an organization’s overall management system, “it can serve as a tool that can dramatically improve not only products and services but also processes and market strategies that create success. ABC does not focus on eliminating jobs-- but does focus on processes that can be changed for the better. Even without the sponsorship required to drive ABC adoption for an entire company, managers can perform informal ABC analysis to improve specific areas they know are broken, but are not certain why.”

ABC is an opportunity creator. However, managers will need to ensure that employees incorporate ABC as a habit back into their old and less efficient practices when things become busy.

Accounting systems will need to be adapted before ABC can be implemented. Finally, the decision-making process will be impacted, including how current managers are involved in making decisions.

ABC has many layers, but when implemented systematically, it can and will fine-tune your daily operations, creating a more fiscally sound and accurate bottom line.

EXAMPLES OF HOW ABC CAN BE USED FOR THOSE IN THE LENDING INDUSTRY

Although there are many ways to maximize the use of Activity Based Costing in the lending industry, here are just a few ways you can quickly impact your organization's bottom line.

- Explore how you can better streamline the process from packaging to closing loan documents.
- Explore how you can improve the process and data gathering on business acquisitions and construction projects since these are some of the more complex transactions.
- Evaluate the use of digital tools rather than printed materials when processing loans.

- Find ways to reduce time spent handling each loan opportunity, such as decision authority and appeals process.
- Explore how creating standardized checklist templates and automated workflows can cut operational hours required per loan, using a software tool like Cirrus.

CLOSING

ABC naturally produces more accurate Costing by essentially converting a broad scope of indirect costs into direct costs of production within your organization. It determines the values of the various sources of indirect costs and then allows you to allocate these expenses to the specific activities that use them.

Setting up an ABC system is time-consuming and can be expensive to maintain but anyone can apply ABC principles using a simple spreadsheet and a clock. Managers willing to sit with their team members and learn where their time is consumed can arm themselves with valuable information that can be directly used to improve the efficiency of processes and increase profit margins.

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