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Product Costing in Practice – The Experience of *MicroSave*[1]

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> *"Allocation based costing allowed Equity Building Society to obtain a range of "quick wins"…[it] enabled us to identify some of the factors that are driving costs within the institution."*

Why bother to cost products? In the right environment, the benefits of product costing can be considerable. Understanding processes facilitates improvements in efficiency and a detailed understanding of cost structures allows more informed pricing decisions to be made. Whilst, identifying sources of profitability (and losses) allows a financial institution to focus on promoting their winning products, and redesigning those less profitable.

MicroSave*'s* work with its Action Research Partners (ARPs)[2] clearly demonstrates that product costing interacts strategically with a huge and diverse range of business areas including pricing, efficiency, outreach, the design of incentive schemes, the identification of the most suitable product mix, marketing, customer service, staffing patterns, profit centre accounting and budgeting. The strategic dimensions of costing are rarely well recognised.

Traditionally, greater attention has been placed on justifying high interest rates than towards ensuring that microfinance programmes operate efficiently. Until ***MicroSave*** started working with its ARPs, though several had costing systems, none fully costed products.

Which costing method? Both allocation based costing and Activity Based Costing (ABC), each has advantages and disadvantages[3].

Allocation based costing is a method whereby each line of the profit and loss account is allocated to different financial products on the basis of a logical criteria called an "allocation base". More details of allocation based costing can be found in ***MicroSave's*** Costing and Pricing of Financial Services Toolkit.

ABC traces costs through significant processes to products. Product delivery comprises a number of separate processes, for example, loan application processing, loan disbursement, loan monitoring and recovery. Staff costs and non-staff costs are allocated to core processes upon the basis of staff time spent. Where members of staff do not directly spend time on core processes but rather provide support functions this time is booked to a general category called "sustaining activities".

Once a cost for a particular core process has been determined based on staff time, costs are then driven through to products on the basis of a logical cost driver. For example, once you have determined the cost for processing a loan application – the cost driver would be the number of loan applications. Each product then absorbs costs for processing loan applications in proportion to the number of loan applications made by each loan product. Different processes will have different cost drivers.

Sustaining activities cannot be driven directly to particular products. The costs of sustaining activities need to be allocated to the different loan and savings products using allocation based costing techniques. More details about ABC can be found in CGAP's Product Costing Tool.

Although, ABC allows a microfinance provider to assess the cost of key processes, which allocation based costing cannot, the choice of which method to introduce should be considered in relation to institutional capability and a range of other institutional factors. Introducing product costing, especially ABC, which is technically more demanding, requires most institutions to have access to training and technical support, which in East Africa is in very limited supply and expensive.

What were the results of costing? In ***MicroSave****'s* ARPs, the identification of loss making products had a significant and immediate impact. Investigation revealed a range of explanations for losses including, poor investment efficiency, inappropriate pricing, an unwillingness to decrease rates to depositors when Treasury Bill rates fell, inappropriate allocation of staff, as well as expensive processes and internal control procedures. Once a loss-making product has been identified further investigation proved necessary, especially in the case of allocation based costing.

With declining Treasury Bill rates fee based products were found to be consistently amongst the most profitable products. Fees are also charged for the provision of specific services within individual products (loan application fees, withdrawal fees etc.). Whilst costing was the major focus of investigation, few of the

MicroSave Action Research Partners coherently relate the price of a product with its cost of provision, the most common pricing strategy appears to be to perform review of the interest rates of the competition and base decisions on this.

Making a transfer pricing adjustment, which accounts for the use of internally generated savings to finance a loan portfolio proved to be important in determining the profitability of savings products, but despite this a number of savings based products proved to be losing significant amounts of money. In several instances it appeared that the savings product was priced too competitively – in other cases more process level analysis is required to determine causality.

Lessons from the costing process When ***MicroSave*** started working on product costing it underestimated the challenges it would face in institutionalising costing within its partner organisations. Costing is institutionalised only when there is evidence that the process is being repeated, that the results of costing exercise are used strategically, that additional investigations are being performed. More sophisticated and capable institutions are able to take the process further and use allocation based costing as the foundation of profit centre accounting, to use costing information in financial modelling, and to move from allocation based costing to ABC. This "process of evolution" is occurring in several of our ARPs, but at very different speeds and to differing extents.

Product costing provides information for the development of new products, though in the case of both activity and allocation based costing the information generated is an imperfect estimation, and therefore needs to be reviewed regularly and against a financial model during the pilot-test phase.

Particularly in the case of allocation based costing additional investigations are required to understand the nature of certain costs, though areas of investigation are focused and targeted by the costing exercise. Initial investigations have investigated, investment efficiency, mobile banking operations, decreasing the cost of particular processes, improving the allocation of staff etc. Where detailed investigation is required, a process audit can be used to unpack a particular process.

Critical Factors for a Successful Costing Exercise

Management Commitment**:** Management need to be fully involved and committed at all stages of the costing process. The Finance Director of one ARP noted that his heavy involvement in the costing exercise allowed him to take the costing exercise further and faster than otherwise would have happened.

Trained and capable staff**:** Allocation based costing is not a difficult exercise, however, exposure to the principles of allocation based costing in a workshop combined with technical assistance is a tested way to create a costing system. In the case of ABC, which is conceptually more difficult, the training and mentoring approach becomes even more important.

Careful preparation: Careful preparation significantly reduces the time and effort involved in developing a product costing system, this usually entails:

- Training the costing team in allocation based costing or ABC
- Ensuring technical support is available should it be required
- Providing staff sufficient time way from other responsibilities to complete the costing process and
- Gathering key information: product policies, procedure manuals, detailed accounts, trial balance, details of transactions and staffing levels.

Resources: Where costing processes were introduced quickly and efficiently sufficient resources were allocated to the process. For allocation based costing the resource requirement is modest, a small team of 2-4 people can normally produce an allocation based costing system where there is a good management information system within a week. ABC is a more complex, longer process, which requires greater data gathering and absorbs correspondingly greater resources. For example, FINCA Uganda committed five staff members who during the course of 10 days gathered and processed data. The team leader then spent several days analyzing the data and producing the costing.

Conclusion

Product costing is an essential tool in developing profitable and efficient financial services through identifying inefficiencies and loss making products. For MFIs focused on achieving the bottom line with outreach it is indispensable.

References:

1. **Cracknell, David and Henry Sempangi** "Product Costing in Practice – The Experience of ***MicroSave***", ***MicroSave*** (2002)
2. **Cracknell, David, et al** "Lessons from ***MicroSave's*** Action Research Programme (2001)", ***MicroSave*** (2002)
3. **Helms, Brigit and Lorna Grace** "CGAP Product Costing Tool", CGAP (2001), available from www.cgap.org/productcosting/
4. ***MicroSave*** "Costing and Pricing of Financial Services" (2002)

For more on Product Costing, visit ***MicroSave*****'s** website: www.*MicroSave*.net under Toolkits section.