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Turnaround Accomplished: Correcting Cost Accounting in Service Organizations

BY STEPHAN M. PINSLY

Often times the complexity of the transactions in service organizations conceals the understanding of the true cost drivers. As these organizations grow, customer offerings usually expand and the ability to maintain cost controls fall by the wayside. A step-by-step approach to understanding the sales fulfillment process and related transaction costs should be undertaken to direct turnaround efforts to the most critical areas.

STEPHAN M. PINSLY, CTP
Managing Director,
Getzler Henrich & Associates LLC

Income statements and balance sheets reflect those values, and comparisons between products and customer profitability is fairly straight forward if tracked properly. This is often true even in distressed manufacturing companies. However, such is not the case when it comes to service industries, especially those that are in trouble.

It is rare to find a standard cost system in a service organization. Revenues and costs may be kept by department but it is rare for accurate gross margins to be calculated based upon actual direct activity. Where possible, the introduction of job costing can be applied to track specific transactions, but the administrative costs could be prohibitive in high volume, low value repetitive sales, especially if there are numerous processes, with many customers using the same facilities.

The traditional view of service organizations relates the revenues to total costs. That may be the ultimate goal, however the "pass/fail" method does not allow for management to influence the outcomes along the way. Also, the esoteric nature of associating activities to costs and assigning those costs to revenues requires an investment in personnel of some accounting sophistication and knowledge of the operations. In cash-strained companies that expenditure often seems like a luxury rather than a necessity and is eliminated or not considered in the first place.

The lack of an accurate costing system in a service organization leads to an inability to gauge the profitability on a customer basis. The only measure of an account becomes revenues. In a single service business that might be sufficient, but as the number of sales offerings increase, without specific costs associated with the revenues, that distinction gets lost. The results are often increasing revenues and decreasing margins.

The marketplace designates the selling prices, however companies that have breakthrough processes and want to promote their advantage would need to know the actual margin being generated based upon true costs. Those organizations that are losing customers because of price need to know their true costs to determine their ability to compete profitably. Without knowing true benchmarks on costs, selling prices will tend to decrease to meet the competition. That should be a signal for management to identify the margin deterioration and begin to address the cost reductions necessary to maintain that product line.

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Accurate costing in service organizations allows management to incentivize sales and marketing personnel based upon margin as opposed to most programs that are based upon revenues. That suggestion usually raises a red flag by those in the selling organization to mistrust the findings and push back on any changes in the approach to commissions historically based upon revenues and not profitability.

Methodology

The process used to arrive at accurate and consistent costing in a service organization requires the setting up of SKUs with standard selling prices and standard costs. Standard costs are determined at a budgeted level of operation with the application of activity-based costing. SKUs should be grouped by product line with a responsible executive assigned as product manager. A customer pricing matrix can exist with the understanding that a pricing report of variances to standard selling prices will be tracked.

Each invoice can be tracked for the standard gross margin by customer. At the end of the designated period, (i.e. week, month, quarter, etc.) the accumulated invoices will give an accurate picture of customer profitability. Revenues and costs can be accumulated by product line to determine how the actual margin compares to the budget.

Costs on a monthly basis are compared to the actual spending to determine the variances by product line. If the standard gross margins are favorable but the variances to actual are unfavorable, the necessary adjustments can be made, ongoing, without waiting for the year to be completed.

Application

In each of the following cases, the board determined that the information being generated by the company gave no visibility to the profitability. Profit margins were not predictable or consistent. Oftentimes when revenues increased, margins eroded. Neither management nor the members of the board felt comfortable with the financial information and always seemed to be behind the curve with respect to correcting the problems. Our firm was engaged to assess the situation, make recommendations to correct the problem and, if necessary, implement the changes.

Technology Services

Problem: A portfolio company of a private equity investor client included a recently acquired "roll up" of a series of electronic data discovery businesses. The company had sales offices in five cities that were located in two states over 1,000 miles apart. Fulfillment operations were conducted in all locations. In addition, certain operating assets, which stored client data, were outsourced. Sales commissions were based upon revenues, including a commission boost for storage revenue.

The company provided a number of different services and products to its customers. Some deliverables had high fixed costs such as printing and copying and others had high variable costs such as programming and coding. Other classifications included data hosting and discovery services, which were mainly contribution income with little additional direct cost. There was no product line cost of sales and no understanding other than "gut feel" as to whether an account was profitable. Pricing was set by market conditions, without a clear understanding of whether or not the revenue was add-on contribution or being sold below variable contribution margin.

The statement of operations made no distinction between fixed versus variable production costs. Administration, distribution and depreciation expenses were considered operating costs. Each month, the gross margin varied wildly and any attempt at financial projections were truly fabricated on a wing and a prayer.

Approach: We asked each cost center manager to calculate his method of costs for each SKU that was billed. We asked them to consider only variable costs. Labor was based upon a fully absorbed hourly rate including vacation, personal time, insurances and taxes. We used a 70% capacity for production hours. We then compared the calculated costs to the actual expenses in the general ledger for the previous quarter. Dedicated fixed costs were assigned to specific product lines based upon the same 70% usage capacity estimate. Standard unit costs were determined for each SKU. At month end, the gross margin by product line, using the actual selling price and the standard unit cost was captured.

Result: The benefit of capturing the cost data allowed the company to compare the actual capacity to the theoretical capacity and adjust accordingly. This method highlighted the high fixed costs and initiated a drive to cut them by introducing certain outsourced technology to reduce the unused capacity. It also uncovered inefficient labor practices by comparing the standards to actual across the various cost centers. Margin contributions captured on a customer basis were instrumental in directing and evaluating the sales personnel. Pricing decisions became transparent to senior management and could be made to strengthen the relationships without incurring any unexpected loss. Overall the company was able to prepare operational budgets based upon estimated future contract activity.

A lack of understanding of the true costs leads to under pricing. Costs and expenses do not get associated with specific transactions and become part of overhead. Profits are assumed, but evaporate when the financial statement is prepared.

Distribution Operations

Problem: Our firm was initially engaged by the board of directors to perform a review of a $500 million public electronics distributor of its facilities in order to reduce costs and identify inefficiencies. The company sold microcomputer products, including mass storage, imaging, display and consumer electronics products throughout the United States and Latin America. It purchased more than 17,000 products from approximately 170 vendors. At the time we were engaged, the company had not achieved profitability for the three preceding years, although revenues had increased by 20%.

Approach: In order to increase the management's understanding of its operating costs and customer profitability, we introduced and helped implement activity based costing into the organization. Every item in the general ledger was allocated to a specific activity. Each customer and supplier was graded by the nature of the activities used. That included services, assets and actual personnel time associated with ordering, receiving, picking, packing and shipping orders. Internet orders were given a different cost from orders generated by sales calls. Picking costs were identified by volume and line order per customer. Management expenses were reallocated by functionality. Expenses of the credit department were identified and allocated by grade to the customers bearing the largest risk and taking up the most time. A variable contribution analysis was generated by customer identifying gross and net contributions. Resistance to accept the new

approach by long-term employees was overcome by an enlightened management team.

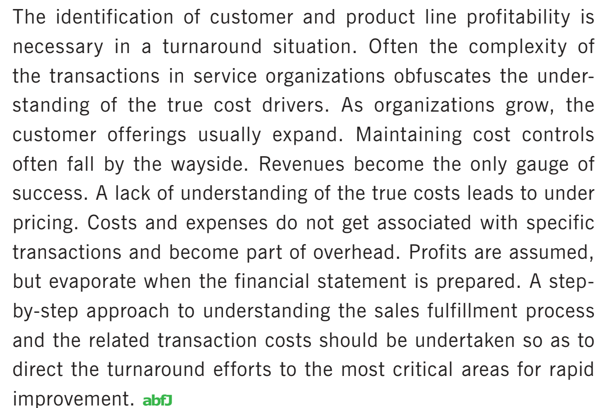
Result: The results were astounding to the board and the management team. They discovered that 39% of all the distribution activity was generating a variable loss. Once the selling prices were realigned based upon actual costs, it became clear that the company was masking certain costs to generate revenues. The management of the company began to pay close attention to profitability by product and by customer. Subsequent to this assignment, the company had increased sales and returned to profitability. The engagement was a catalyst for positive change that otherwise would not have been achieved.

How Do You Start?

Assessment: Each business operator needs to understand the process of generating revenues at the time that its customer decides to make a purchase. There have been many books and white papers written about the implementation of activity based costs and transaction analysis. The first step is usually a physical review of the process and the reconciliation of those expenses to the general ledger. That includes all costs and expenses, even those below the traditional cost of sales line. The goal is to arrive at a contribution by product and by customer that includes all variables.

Implementation: The next step is to apportion all the related expenses based upon the volume of transactions that occur and to grade the activity based upon the time and resources used. This creates a cost value to the transaction. All transactions for every customer and each vendor is then calculated to determine the nature of the activity. Once that information is obtained, vendors and customers that incur those specific transactions can be allocated the respective graded cost based upon the true absorption of the company's resources. Depending upon the sophistication of the company's computer system, these transactions can be coded and tracked as a byproduct of the financial history.

Result: The information generated by these methods will change the way customers and vendors are managed. It will allow all employees to understand how the company spends its resources. The process brings to light the value added by the company to the transaction. By attributing costs to activities and then assigning those costs to purchase orders, it provides a true picture of the all-in cost of the products and services sold.



Conclusion

The identification of customer and product line profitability is necessary in a turnaround situation. Often the complexity of the transactions in service organizations obfuscates the understanding of the true cost drivers. As organizations grow, the customer offerings usually expand. Maintaining cost controls often fall by the wayside. Revenues become the only gauge of success. A lack of understanding of the true costs leads to under pricing. Costs and expenses do not get associated with specific transactions and become part of overhead. Profits are assumed, but evaporate when the financial statement is prepared. A step-by-step approach to understanding the sales fulfillment process and the related transaction costs should be undertaken so as to direct the turnaround efforts to the most critical areas for rapid improvement. abfJ

STEPHAN M. PINSLY, managing director, of Getzler Henrich & Associates, is a veteran chief financial officer and chief operating officer of public and privately owned middle-market corporations, providing strategic turnaround leadership for 30 years. He has accumulated a wealth of experience in solving intricate, difficult debt refinancings and complex business viability issues. His industry expertise spans across many business types, from distribution, manufacturing, services and retailing companies. Pinsly began his career at Price Waterhouse & Co. after receiving a Bachelor's degree in accounting from Queens College, CUNY. Following that, as an entrepreneur in a private investment firm, he participated in transactions related to the acquisition and disposition of distressed companies. Prior to Getzler Henrich, he served four years as a director and senior vice president of a regional middle-market turnaround management consulting firm. Pinsly is a certified turnaround professional and a CPA. He is a member of the TMA as well as the American Institute of Certified Public Accountants and the New York State Society of Certified Public Accountants. He can be reached at spinsly@getzlerhenrich.com.

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