

## **Top Down vs. Bottom Up**

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***Financial service companies are currently implementing or planning to implement the last major improvement to management reporting.***

This change will significantly upgrade the quality and quantity of information available to support the professional management of the business. They are moving from a top down design to a bottom up design for expense distributions and activity based costing is at the heart of it.

This change clears away the controversy surrounding management reporting and provides actionable insights into product profitability, customer profitability, line of business profitability, staffing and resource management, productivity, and target re-engineering.

At most financial service companies, internal P&Ls (Organizational, Product and Customer) have been completed satisfactorily except for expense distributions. Revenue accounting, internal funds accounting, risk adjustments and capital allocations are basically in place. While there may be some user discord about particulars, the overall methodology is in place. This is not the case with expense distributions. Expense distributions are the most contentious area remaining and one that precludes user acceptance of the P&L itself.

The issue of expense distributions arises from the following situation. In organizational profitability reporting revenue is booked into profit centers. Expense is booked into every center in the institution and is booked by natural classification: salaries, benefits, occupancy, depreciation, etc. The challenge is to credibly and accurately move the expense to the appropriate revenue. This becomes more problematic in product and customer profitability reporting.

## **TOP DOWN**

Top down originally got its name from the concept of allocating expenses on a percentage basis. Today, however, it represents all types of accounting (including rate X volume) which allocate 100% of expenses to current period revenue. This section addresses the methodologies that are used in top down accounting and the issues and bad decisions that arise from its use.

### **Expense Allocations**

Many of the business managers we talk with are dissatisfied with their organizational and product profitability calculations because of expense allocations. In customer profitability, their dissatisfaction level rises exponentially. Profit center managers, product managers, and customer relationship managers in companies that use expense

allocations are frustrated with the profitability information they receive. They do not believe the expense amounts allocated to their P&Ls and cannot understand the validity of the allocations. In addition, they can't articulate the problem or understand the amounts they should have been charged. As a result they usually wind up blaming back office managers for overspending and bickering with finance managers over the allocation rates and rules.

Expense allocations are adversely impacting management's ability to make informed decisions regarding customers, products, markets, and channels. In financial services, sometimes it's hard to see the absurdity in the allocation result because the companies are so large and complex. It's difficult for users to understand whether a wire transfer really costs \$23.00 or \$2.30. When the allocations arrive all they can do is complain. A large number of companies that have installed profitability systems that employ expense allocations are currently rethinking their designs because of management's dissatisfaction.

Business manager frustration rises exponentially when expense allocations are used in customer profitability because allocations result in 100% of channel expense being allocated no matter how much of the channel customers have used. Can you imagine how frustrating and demoralizing it is when you successfully divert a large percentage of your customer base from a very costly channel to a less costly channel and 100% of the costly channel is allocated to your P&Ls anyway? Allocating 100% of the expense of positioning channel resources to current period customer revenues misstates customer profitability and leads to poor decision making.

Using expense allocations is analogous to a supermarket determining profitability by subtracting the cost of all the goods they put on their shelves from the day's receipts, instead of subtracting just the goods that were purchased. The cost of generating the revenue is the amount of resource consumed by the customers not the amount of resource positioned.

### **\$700,000 Porsche**

To better understand the problem bankers are having understanding the information generated by their profitability systems, let's get out of banking for a minute and go into a business where it's easier to relate to the amounts. Imagine you put up your capital (so you really have a net income focus) and buy a Porsche dealership. That feels pretty good, owning a company. Now you wait for sales. A lot of people come in to look at the cars. They sit in them; they touch them; but no one's buying. Finally someone buys a car for \$100,000. You get to the end of the month and it was the only car sold. Now you turn on the typical profitability system and it reports that you sold a Porsche that costs \$700,000 for \$100,000. Now what do you do? Do you try to figure out how to sell Porsches for \$800,000? Or do you get out of the business because the product is unprofitable?

Obviously the car didn't cost \$700,000. And yet the profitability system allocated 100% of the actual expenses of the dealership to the product. The total dealership incurred a loss with \$700,000 in expense and only \$100,000 in revenue. But management needs to know that the Porsche only cost \$80,000 and there's a great margin on the product (product profitability) and you have unused resource to manage. Management also needs to know that the customer that purchased the car is also very profitable (customer profitability) and is the kind of customer you want to profile and target market.

### **Incremental Pricing**

In fact, management in a number of these institutions were resorting to "incremental pricing" in an attempt to get around the onerous top down allocations. Since they couldn't hope to price to recover the full allocations (price the Porsche at \$800,000) they price only to cover the incremental increase in expenses associated with the additional resources required to process the new work. This is a flawed strategy because it assumes the core customers that are covering the existing expenses are stable and will not leave the bank. A line of business head in a major New York City bank put it well: "Incremental pricing only results in reductions to net income. While I'm incrementally pricing to steal the core customers from my competition, they are incrementally pricing to steal my core customers. Both banks lose and the only winner is the customer." Bankers need realistic information to properly understand the dynamics of the profitability of their product offerings. Only then can they create the win/win offering that is attractive enough to retain profitable customers and profitable enough to generate an attractive return for shareholders.

### **Fluctuating Amounts**

Another major issue with expense allocations is the large fluctuations that exist month to month. Since the system allocates 100% of expenses each period, the amounts allocated fluctuate as the distribution basis (volumes, etc.) fluctuates. This creates a moving target that does not support decision making. We assisted a major financial service company that was using expense allocations. They had previously formed a pricing committee of senior executives to review and set prices. Each month they would pick products to address and would ask the finance department to supply the product unit costs. The mistake they made was not asking for the same product two months in succession. If they did, they would have received unit cost numbers that fluctuated materially from one month to the next. The unit costs they received were not product unit costs, they were expense per unit and they fluctuate each period. They should not be used to support pricing decisions.

### **Rippling Effect**

Another problem with expense allocations is the rippling effect. Since these allocations always account for the entire universe any change anywhere in the company ripples through every P&L in the company. We have a great anecdote from a major mid-

Atlantic bank. They had sold their credit card division to a mid-Western bank. After the transaction was completed the finance department ran the P&Ls for the next month. Once the reports were distributed they received an irate call from the head of commercial banking. He wanted to know why his net income had declined so materially. The finance explanation, of course, was that the company had sold off the credit card division and the profitability system had allocated the remaining expenses that had been previously allocated to credit card. The executive said: “it doesn’t make sense that the sale of a retail product line should adversely impact the commercial banking P&L”. The unfortunate reply from finance was: “it may not make sense from a business perspective but it does make sense from an accounting perspective”. This is a classic disconnect between finance and the business lines and is caused by the top down approach.

### **Variations on a theme**

Some companies have adopted the top down design and sidestepped the rippling and fluctuating effect. They allocate 100% of expenses but do it with a fixed rate X volume. This creates the same basic problems as a percentage allocation. The price for eliminating the fluctuations is a large variance that accumulates and ultimately needs to be addressed. The common term for this is “true ups”. By definition it implies the previous numbers were wrong and now they will be corrected. The worst case of this we encountered was a large mid-Western bank who accumulated the true ups throughout the entire year. In December they would distribute the variances and cause considerable consternation throughout the company. All of those managers who thought they were operating at the reported level of profitability received a year end surprise that adversely impacted their results and their compensation.

### **BOTTOM UP**

Bottom up is the distribution of the cost of generating revenue to the revenue that was generated. This is not just rate x volume; it’s accounting for the expense of positioning resources, how customers consume them, and how much resource was positioned but not consumed.

### **The True Nature of Operating Expenses**

There are two important components to measuring and managing the financial service company, and both should be evident in the accounting. The first is measuring how much resource was positioned to service customers and to process the transactions they create. The second is measuring how much of that resource was actually consumed by customers. Operating expenses, for the most part, are incurred in the positioning of resources. What is the expense of positioning resources? It’s the salaries and benefits of the employees who do the work, the expense of the space they occupy, the expense of the equipment and supplies they utilize, the expense of heat, light, and power, etc. It is also the expense of positioning computing resources.

These valuable resources are the employees and the computers of the company that process the work, interact with customers, and handle all of the day-to-day activities that keep the bank operational. Allocating 100% of these expenses to revenue each period, without consideration for what they did or how much they did, creates false pictures of the business and leads to bad decision making.

### **The Role of Activity Based Costing**

Activity based costing comes in two flavors. The first is where activity measurements are used to allocate 100% of expenses (top down) to activities and then to products, customers and profit centers. This methodology should be called “activity based allocations” instead of using the name “activity based costing”. This method results in the same old problems that business managers hate. It is the top down approach masquerading as activity based costing.

The second is when activity based costing follows the concepts of full capacity costing and as a result provides true insights into the nature of profitability, how capacity is positioned and utilized, and the impact of customer behavior on net income. Financial service companies that use this method of activity based costing are creating usage-based charges to profitability statements with channel identity. Activity based unit costs multiplied by the volumes processed measure the usage, and the amounts appearing in the profitability statements actually reflect the amount of resources consumed by customers as they purchase products and services from the bank (cost of generating revenue). If capacity goes unused it's reported as unused capacity.

The key to creating this information is double entry bookkeeping. Most profitability systems are created with the design emphasis on the debit side of the calculation. This results from the emphasis on 100% allocation from back office to front office. However, profitability systems that have been designed to take advantage of the power of activity based costing have placed design emphasis on both the debit and credit side of the calculations. This allows for a charge to the P&L with channel and product identity and a credit to the center that did the work with channel and product identity. Creating information on both sides of the transaction is what links P&Ls with channel utilization reporting.

### **Shortcuts**

There are a number of shortcuts to creating profitability information, but they don't enhance decision making. One shortcut is to bypass the cost accounting and use industry averages. While this may be expedient, it doesn't provide credible information. It doesn't identify how your customers consume the resources your company has positioned. Profitability information is too important to guess at the answer. The decisions arising from this information impact the very core of your business.

Another shortcut is to estimate the costs. This saves money in the short term but is more expensive in the long term. By estimating the costs you are missing the profit opportunities that arise from analyzing properly created metrics. It is very profitable to accurately and credibly create and deploy activity based costs and integrated profitability reports. The expense of the project is easily recovered from the profit improvement opportunities that emerge from the rich information content.

## **IMPROVED DECISION MAKING**

This section presents some examples of an improved decision making environment when using the bottom up approach to expense distribution.

### **Products and Customers**

A profitable offering targeted to specific customers or customer segments is the key to sustaining long term profitability and growth. The key to designing the offering and targeting the proper segment lies in understanding customer profitability. Customer profitability should be calculated showing the products the customers purchased, the channels they used and the cost of the resources they consumed. If customer and product P&Ls are created using expense allocations then the results are not representative of the real relationship or the real offer and will lead to bad decisions. Bottom up accounting provides the insights that are essential to strong decision making.

During a speech at a strategic marketing conference I asked the attendees the following question: “If you are successful in diverting 50% of your customers out of your most expensive channel and into a less expensive channel how much more money does the company make?” The attendees were predominantly marketing executives but knew the correct answer to my accounting question. The bank doesn’t make any more money until the resources in the first channel are reduced or redeployed to reflect the declining usage.

If companies are going to continue to design and offer lower-cost delivery channels to their customers, they must aggressively manage the resources positioned in all channels. Customers don’t announce their transaction intentions or their channel preferences; they move between channels at will. The best companies are identifying the impact of channel usage in their profitability calculations and they are tracking channel utilization to optimize resource management. As a result, they have a competitive advantage and are sustaining profitability and growth.

### **Local Market Profitability**

The concept of managing local markets is certainly a sound one; however, for most banks the measurement of local market profitability has been inadequate. Why are local market measurements so inadequate, how does local market profitability differ from customer profitability, and how does local market profitability change over time? These questions are being addressed effectively at a number of best practice banks.

A local market is defined as a specific demographic area that is serviced by a branch or cluster of branches. Best practice banks want to view local market results from a number of perspectives. They want to know location profitability. That is the profitability of the customers in that location. They want to know this in aggregate to be able to compare markets and to target attractive markets to penetrate. They also want to know individual customer profitability to identify customers for target marketing. Lastly, they want to know how the location is being utilized by walk in customers. This is different from profitability because the walk-in customers may actually be customers of record of other branches or local markets.

The difference between local market profitability and customer profitability is that customers can move to other local markets and still be customers of the bank. The movement of customers over time is very important as it impacts the very nature of local market demographics. We all know how neighborhoods change. Look at property values over time. Wouldn't it be wonderful to track local market profitability over time to track the results of your efforts to improve profitability as well as the ebb and flow of profitability as customers move in and out of those markets? A very profitable location could become the most unprofitable over time.

Measuring and managing local markets involves the two most important measures of a branch or location: profitability and productivity. How profitable is it to have a presence in a specific location and what's the productivity of the people who staff the location to service the walk in business.

Local market profitability is the revenue of the customers of record of the local market less the cost of generating that revenue. Unfortunately not many banks are computing the cost of generating the revenue. Most banks misstate branch profitability by taking the revenue of the customers of record of the branch and subtracting the direct expenses of the branch and some allocated expenses. The direct expenses of the branch are the expenses of positioning resources in the branch to service the walk in customers from any branch. This mismatch of revenue and expense distorts results and adversely impacts decision-making.

Leading banks that utilize the bottom up approach are employing profitability measurement functionality known as inter-branch accounting to reconcile branch of record and branch of process and to clean up the mismatched reporting. They are creating two different reports to support the two primary views. One is an integrated P&L showing local market profitability by product and the other is a capacity utilization report that shows how effectively resources are positioned to service the walk in customers.

## **Customer Behavior**

Customer behavior is apparent in the financials when using activity based costing in the bottom up approach. Since the charges to the P&L are usage based and reflect the channels the customer utilized and the resources they consumed, the P&Ls reflect the impact of customer behavior on net income. Behavior is evidenced by the size of the balances in their accounts, the number of transactions they create, the channels they use and the fees they pay. In combination this is the story line behind understanding and analyzing customer profitability.

We worked with one bank that had been creating retail customer P&Ls for a number of years using the bottom up approach. They had retained all of that history in their data warehouse. Someone in their marketing department came up with a brilliant idea. The retail bank had adopted a company wide objective of retaining their profitable customers. The marketing manager suggested that they use their predictive modeling software and look at the last three years of customer P&Ls and search out the profitable customers that had left the bank. They decided to look at the last ninety days of their behavior and apply what the software learns to the existing customer base and identify the customers that are planning on closing their accounts. The software came back with a list of names of customers likely to close out their relationships.

The marketing department assembled lists by branch and sent them out to the branch managers. One of the branches called to say they received the list around noon and found that one of the names on the list had closed out their relationship at 10 a.m. that morning. This obviously enhanced the credibility of the effort and word spread throughout the branches. Their calling efforts succeeded in retaining many of the customers on the list.

There are numerous examples of profitable decisions arising out of bottom up information that provides insights into the businesses. The key is getting beyond the bickering over rates and rules and forming a partnership with line of business managers that result in a consistent approach to sustaining profitability and growth.

## **CONCLUSION**

Management accounting should align with how managers run their businesses and how they make decisions. If management is that great discipline they teach in business school and the great art that Peter Drucker writes about, shouldn't management accounting be the accounting for that great management? Moving to a bottom up design will finally provide that alignment and elevate management reporting to its rightful place in the company.

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