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Cost accounting for trust operations

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COST ACCOUNTING FOR TRUST OPERATIONS

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During the past several months, Haskins & Sells has been writing a new cost manual for the Bank Administration Institute. This afternoon I would like to tell you briefly about the contents of this forthcoming book titled *Bank Costs For Planning and Control* and discuss the application of this costing approach to trust departments.

In 1951 the Bank Administration Institute published *Bank Costs*. That manual uses many illustrations and leads the cost accountant through a multitude of computations to arrive at cost. It includes little discussion of the uses of cost or considerations to be made in the cost computation.

Bank Costs For Planning and Control takes a different approach. It states that costs should only be calculated with a particular purpose in mind and that if the purpose of the cost calculation changes, the cost amount may change.

Let us look briefly at the table of contents in Exhibit 1. Part I explains the use of cost by bank management. Part II discusses the costing process and the characteristics of bank costs. "Cost for Planning and Control of Resources" is the title of Part III. Chapter 8 of Part III points out that a responsibility center accounting system is the first step in the installation of a bank cost system and a major source of data for many cost computations. Part IV, "Allocation Techniques," is for the accountants. Not really. If you are going to compute costs for individual accounts you must be concerned with measurement of activity and cost allocation.

Once you have mastered "Allocation Techniques," you are ready to make costs work for you. This is done through profitability analysis, using costs for control, or computing costs as a basis for establishing fees. The discussion of standard costs and data center costs completes the manual and serves to review its more significant arguments.

TRUST DEPARTMENTS DON'T HAVE SPECIAL COSTING SITUATIONS

You may notice that there is no special section on trust departments. This is because the costing problems of the trust department are similar to those of the rest of the bank and even to many organizations outside the banking industry. There are many similarities between your business and that of a stockbroker, or a large law firm, or even a firm of certified public accountants. You render a service where costs are related to professional time spent on a particular account and to the activity of the account. These things can be measured and costs computed. But before we discuss the mechanics, let's review the uses of costs. Why bother with them anyway?

COSTING FOR PROFITABILITY

First there is the question of profitability. Regardless of what your bank's other goals or accomplishments may be, it is the ability to make a profit over the long run that permits it to exist. Profitability can be analyzed for the trust department as a whole and by the types of service it renders – that is, personal trust, custodian, investment management, corporate trust, probate, etc. Profitability of individual trust accounts can also be analyzed.

Profitability is a guide to selection and management of resources. Analyses may be prepared that lead to dropping or adding a profit area; to expansion or promotion of certain services. In these analyses it is especially important that relevant costs be included.

Your trust department is different from that of everyone else in this room. There are things that yours does better than others; there are other things that yours doesn't do as well.

Your costs are different from those of other trust departments. Perhaps you have a better system for a certain activity. Perhaps you have a group of exceptionally bright trust officers. Perhaps you have a good mix of accounts. Regardless of the reason, your costs are different. Your bank would do better if you knew in which areas of the trust business you had a competitive cost advantage and those areas were promoted. It would do better if you knew in which areas you were at a disadvantage and those areas were de-emphasized or discontinued.

You have limited resources, a limited staff and a limited number of hours in the day. Your time is valuable and should be spent in the more promising areas.

COSTING FOR CONTROL

A second use of costs is control. Control presupposes a plan related to responsibility units of the organization and a periodic measurement of results against the plan. The plan may be related to responsibility centers or to profit centers. There is a difference. When the plan is expressed by responsibility centers, management is assigning responsibility only for control over revenues and expenses, but not profit. A true profit center system assigns responsibility for profit and must be accompanied by the authority to establish fees and to control acquisition of new business.

The choice between a responsibility center system and a profit center system is a choice of management style. Certainly a good responsibility center system provides better control than no control system at all or a system for the bank as a whole. In practice, however, individuals tend to assume more responsibility than that given them.

Profit centers have definite advantages:

They provide workable units of control when the size or complexity of the bank may make it desirable, perhaps even necessary, to delegate profit decisions to lower levels of the organization.

They provide strong motivation to a manager to meet profit targets by encouraging him to view his responsibility as he would a separate business entity.

In certain situations, the development of a strong profit motive in individual managers can cause them to make decisions that might enhance the profits of their units but might be detrimental to the operations or profits of the bank as a whole. It is the responsibility of senior management to maintain a system in which the objectives of the whole bank are passed on in the form of profit objectives to the individual profit centers. Equitable cost allocation is also necessary to achieve this result.

COSTING TO SET FEES

Another use of costs is in setting fees. I understand that few of you use a highly developed cost system. How do you establish your fees? Certainly the value of the service has a major role. Competitive forces must be considered. Cost also has a role.

Let's move on to the computation of costs. I don't intend to discuss all the techniques of measuring activity and allocating costs. We will confine our discussion to five steps.

FIVE STEPS IN COMPUTING COSTS

1. *Define The Purpose* First, one must define the purpose of the cost calculation. Why are you doing it? Do you want to control the trust department or are you going to review your fee schedule? Defining the purpose sounds so simple that you may wonder why it is recognized as a step. It is establishing the objective. Results may vary depending on the purpose.

2. *Define The Costing Object* The second step is defining the costing object. A costing object is the thing being costed. It may be a type of service or it may be an activity common to several types of services. The costing object may be the trust department as a whole.

3. *Specify The Cost Data* The third step is to specify the cost data. Data selection involves:

Identifying the cost data that are associated with the resources that comprise the costing object

Identifying the sources and determining the availability of each type of cost data

Screening out data not relevant to the purpose of the calculation

Screening out data not material to the outcome

Determining the degree of precision required in the data

4. *Specify The Allocation Process* Step four is to specify the allocation process. Allocation is the most complicated aspect of costing. Specifying the allocation process involves:

Determining the allocation basis

Determining the transfer unit

Determining the allocation method

Examples of allocation bases are time required to process a transaction, number of employees, space occupied, etc. The allocation basis is the common denominator used where cost transfers are required. The transfer unit is simply one unit of the allocation basis, e.g., square feet, hours, etc. An allocation method prescribes the sequence in which costs are distributed to the costing object. The allocation method should reflect the actual cost flow.

5. *Calculate The Costs* The fifth step, calculating the cost, involves:

Assembling the data

Measuring the activity

Calculating the unit transfer cost

Extending and totaling the results

As I said, allocation is the most complicated aspect of costing. You may wonder whether allocation is really worth it. You've probably heard too often that someone must pay the president's salary. In a few cases allocation may not be necessary. In others, less than complete allocation might suffice.

LEVELS OF PROFIT CONTRIBUTIONS

Let us look at the situation where profit centers are used for control. Should the profit center manager be held responsible for all costs charged to him or only for those costs he can influence?

There are four levels of profit contribution that can be used in making profit decisions. Each results in a different quantitative measure of profit. If the same level is used for all profit centers, the results are equitable to measure performance. Let's review the levels:

Level 1 Profit Contribution – Revenue After Direct Controllable Costs

Includes those costs that are both directly incurred by the profit center and for which the profit center manager has responsibility.

Level 2 Profit Contribution – Revenue After Direct and Allocated Controllable Costs

Includes those costs that are directly incurred outside the profit center but for which the profit center manager does have responsibility.

Level 3 Profit Contribution – Revenue After Controllable and Allocated Non-Controllable Costs

Includes those costs that can reasonably be assumed to be incurred on behalf of the profit center but cannot be directly related. These costs are not under the direct control of the profit center manager.

Level 4 Profit Contribution – Revenue After Controllable, Non-Controllable and Arbitrarily Allocated Costs

Includes those costs that are allocated on some arbitrary basis in order to reflect the profit center's share of administrative overhead. Here again, these costs are not under the direct control of the profit center manager.

Separating costs into these levels places emphasis on the "controllable" items of cost rather than on the "non-controllable" items. An even greater performance emphasis may be put upon those costs for which the manager has administrative responsibility.

AN EXAMPLE

Exhibit 2 which follows is based on the actual fees and costs of a $50 million trust department. I don't mean to comment on the profitability of trust operations in general; this example was just readily available. I should note that this trust department generated an estimated average balance of $570,000 in investable funds which yielded an estimated $30,000 income.

What would you do if faced with this situation and a new management that placed emphasis on profitability? There are many things you could do:

Evaluate the future growth of revenue

Identify operational improvements that can be made to reduce costs

Calculate the potential business available through the wills on hand for processing.

Determine what new services could be introduced and their profitability

Determine what current services operating at a loss can be dropped

Identify specific customers or classes of customers that are regularly being served at a loss and take corrective action.

All of these things involve profitability analysis. Based upon these analyses, management should develop plans for improvement.

ACCOUNT COST ANALYSES

To analyze all of your accounts on an annual basis could be made into a tremendous undertaking. For this reason some banks have established cost accounting records for individual accounts. Standard rates are determined for the various clerical activities. Officers report time by specific accounts. Overhead costs are accumulated and allocated to individual accounts on a specific basis.

Exhibit 3 is an example of a cost sheet for a bank employing such a system. Note the standard rates for each activity. Standard hourly rates are also used for the officers. Finally annual income is estimated and compared to the trust fee.

Such a cost accounting system has several advantages:

Productive use of officer time will most likely increase

Unit activity costs can be charted over a period of years and unfavorable trends studied for correction

The profitability of a new account can be forecasted and appropriate action taken in specifying the fee

Such systems are not really complicated. How many banks would loan commercial enterprises funds, if the business lacked a reasonable cost system? But how many of you know your costs?

We have made a general review of cost accounting as it applies to banks and to trust departments in particular. The important thing for you to remember is that cost accounting is a tool. Costs can be used by you to manage your department more effectively.

None of you can totally disregard costs. You work for profit making organizations. To some degree you must be mindful of costs and control them.●

EXHIBIT 1

BANK COSTS FOR PLANNING AND CONTROL

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EXHIBIT 2

THE ILLUSTRATIVE BANK & TRUST COMPANY

Trust Department Income Statement
Year Ended December 31, 1971

Fee income	$125,700
Direct controllable costs	126,100
Revenue (loss) after direct controllable costs	(400)
Allocated controllable costs	40,500
Revenue after direct and allocated controllable costs	(40,900)
Allocated non-controllable costs	15,300
Revenue after controllable and allocated non-controllable costs	(56,200)
Arbitrarily allocated costs	5,400
Revenue after controllable, non-controllable, and arbitrarily allocated costs	$(61,600)

EXHIBIT 2 (continued)

THE ILLUSTRATIVE BANK & TRUST COMPANY

Trust Department
Direct Controllable Costs (Level 1)
Year Ended December 31, 1971

Salaries and wages	$ 75,800
Group life and pension plan	5,000
Payroll taxes	3,300
Employee training	300
Machine rental	300
Maintenance and repair	600
Dues	100
Entertainment	500
Insurance	100
Legal and professional	19,800
Promotion	2,000
Subscriptions	1,500
Supplies	1,200
Telephone and telegraph	200
Travel	900
Advertising	13,300
Miscellaneous	100
Miscellaneous losses and recoveries	1,100
Total direct controllable costs	$126,100

EXHIBIT 2 (continued)

THE ILLUSTRATIVE BANK & TRUST COMPANY

Trust Department
Allocated Controllable Costs (Level 2)
Year Ended December 31, 1971

Personnel	$ 2,400
Telephone	3,500
Mail and messenger	1,400
Business development	15,800
Rent on bank premises	13,900
Depreciation	3,500
Total allocated controllable cost	$ 40,500

Trust Department
Allocated Non-Controllable Costs (Level 3)
Year Ended December 31, 1971

Institutional advertising	$ 10,000
Examination fees	5,300
Total allocated non-controllable cost	$ 15,300

Trust Department
Arbitrarily Allocated Costs (Level 4)
Year Ended December 31, 1971

Directors' fees	$ 1,000
Office of the President	1,500
Controller	800
Auditing	2,100
Total arbitrarily allocated costs	$ 5,400

EXHIBIT 3

THE ILLUSTRATIVE BANK & TRUST COMPANY

Account Cost Analysis
Year Ended December 31, 1971

Account No. 02-1234

Activity Expense	*Item Count*	*Item Cost*	*Total Cost*
Sales – Stocks	2	$ 6.05	$ 12.10
– Bonds		6.15	
Purchases – Stocks	2	8.45	16.90
– Bonds		6.50	
Deliveries – Stocks		5.50	
– Bonds		4.65	
Receipts – Stocks		5.00	
– Bonds		2.90	
Other Principal	3	1.20	3.60
Dividends	40	65	26.00
Interest		90	
Real Estate		–	
Other Income Receipts		20	
Income Payments	12	1.90	22.80
Expenses		1.45	
Fees	5	1.15	5.75
Requisitions	1	95	95
Cash Statements	8	1.30	10.40
Holdings			
Stocks – Guidance List	8	7.30	58.40
– Others	2	12.95	25.90
Bonds – Governments		2.10	
– Others		2.70	
Common Fund – Per Unit			
– Stocks		.09	
– Bonds		.03	
– Municipals		.02	
Loans		5.35	
Sundry Assets		1.05	
Real Estate		–	
Liabilities		4.25	
Fixed Cost Per Account	1	36.00	36.00
Total Activity Expense (forward)			218.80

EXHIBIT 3 (continued)

THE ILLUSTRATIVE BANK & TRUST COMPANY

Account Cost Analysis
Year Ended December 31, 1971

Account No. 02-1234	*Hours*	*Rate*	*Total Cost*
Total Activity Expense (forward)			$ 218.80
Diary Expense			
Group Vice President		$50.00	
Vice President		28.00	
Second Vice President		22.00	
Assistant Secretary	4.0	15.00	60.00
Clerical		7.00	
Total Diary Expense			60.00
Total Direct Expense			278.80
Indirect Expense			175.00
Total Expense			453.80
Fee Collected			573.80
Profit			$ 120.00
Estimated Annual Income			$5400.00
Collected Fee/Income			10.6%