How Product Costing can help MFIs business strategy

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Preface

After 25 years of continuous development within the microfinance sector, many institutions are facing very competitive, mature markets, with even more regulation and declining lending rates. This scenario represents a challenge not only for sustainability but also for strategic planning. In this context, product costing is imperative and its benefits are not only limited to cost-profit analyses, since it also serves as a starting point for identifying strategy deviations and business model inconsistencies.

Introduction

Product costing was not a priority in the early years of the microfinance industry, since high demand, lack of regulation and high interest rates allowed institutions to afford the high operating costs derived from inefficiencies. This favorable environment has dramatically changed over the last decade as markets become more competitive and/or more regulated, thus leading to significant interest rate decreases. In this context, the most vulnerable institutions are those with less financial support in the event of a potential price war, and especially those with less knowledge of their product costs. Indeed, many organizations are increasingly demanding more efficient costing methodologies that allow them to identify the real causes of costs, and to measure product profitability more accurately.

A reliable costing methodology also provides information which is vital for decision making on the following:

1. Product pricing, through more exact knowledge of profitability levels
2. Investments, through the reallocation of resources to more profitable products.
3. The enhancement of MIS (management information systems) with vital information on the marginal contribution of each product.
4. Budgeting, based on reliable cost information.
5. The development of cost centers.
6. The raising of cost awareness among managers.
7. The development of appropriate incentive systems for staff.
8. The use of benchmarks to compare the performance of different products, branches and loan officers.
10. The analysis of strategy and business model components.

This last benefit is often not even considered when implementing product costing, although there is a quite obvious direct relationship between an unclear strategy and an increase in costs. It is at this point that key questions arise:

- Which methodology gives a better understanding of the real causes of cost increases and their strategic impact?
- Are inefficiency and bad practice the only causes of cost increases?
- Can an organization have efficient processes and yet have a business model which conditions the cost structure?
- Does incorrect market positioning have an impact on cost structure?

**Traditional Costing Methodology vs. ABC Costing Methodology**

In order to calculate product costs we basically count on two different methods:

i) **Traditional product costing**, which assumes that operational volume causes costs, for example, the number of loans disbursed, the number of loan applications, and so on, and uses these criteria to distribute cost among products.

ii) **Activity based costing (ABC)**, which calculates product costs based on the activities and processes involved, and uses time spent on each activity as the real cost driver.

**Figure 1**

The first methodology is easy to calculate but inaccurate, since the use of volume as a cost driver has been proven to cause distortions. ABC costing is very precise, although more complex to implement, and is without a doubt the best way to determine inefficiencies. The following figure explains allocation differences between the two methods.
A systemic approach to product costing

One of the most important advantages of ABC costing is the easy identification of real cost triggers, which allows a deeper understanding of how and where to reduce costs related to processes and best practices. However, after measuring product costs and correcting deviations, there may still be higher costs compared to those of the competition. *This is a sign of inconsistencies in an organization’s strategy and its business model, or a lack of synergy between components, in which case a deeper analysis will be needed.*

A business model describes what an institution offers to its customers, how it does it, and ultimately how it generates profit. The model should be consistent in itself and with its mission, vision, strategies, resources, organizational structure and, of course, its market needs. In this context, best practices in credit technology and processes are just two of the business model’s components, as shown in detail in the next figure.

**Figure 2**

Although this illustrates the many hard and soft components of a business model, its real purpose is to show that analyses cannot be carried out in isolation, and that the real causes of cost increases should be determined systemically. It is therefore important to stress that a cost methodology can determine the symptoms (traditional cost accounting method) or the real causes of costs (ABC costing method) as long as they have a direct relationship with processes or activities (organizational structure components). However, it cannot provide a specific answer if the underlying problem has its origin in any of the other variables of the business model.

For instance, a product design error or a problem of organizational culture may be the real triggers of higher costs, but this is very difficult to detect with the costing final results. Despite this restriction, these can be used as a starting point for further research, as shown below.

Should deficiencies remain after applying the ABC methodology and improving processes and best practices, the analysis should then focus on any other components of the business model that more accurately explain the higher institutional costs.

At this stage, the reliable figures provided by ABC Costing can be used for deeper research, not only into the individual components of the business model, but also into their interrelationships and potential for synergy, and finally into institutional strategies themselves. Although these might seem unrelated to product costs, when cost differences between branches, areas or processes are analyzed and compared with internal and external benchmarks, the result often leads to important strategic issues. For example, questions usually arise when an institution has the same salary costs...
and similar processes and productivity as its competitors, and yet profitability is substantially lower. This discrepancy is even more puzzling if it is found within similar branches of the same institution, especially when they deal with the same product. In this case, if the cost information is reliable, then the business model and the way its components are interrelated should probably be rethought, and this will often lead to a reengineering process.

To summarize, even the most reliable cost methodology will not be able to determine all the direct cause-effect relationships that explain why a product is more expensive when compared to the corresponding benchmarks. However, the accuracy and reliability of ABC costing can help to detect indirectly which components are not in line with the strategy, thus serving as a starting point for deeper analysis and change.

The impact of incorrect strategic positioning on cost structure

In the above mentioned systemic approach, it is clear that all business model components should be considered when analyzing costs; although one of the most important is the unique selling proposition (USP)¹, as shown in the center of Figure 2. The USP is basically what sets a product or service apart from the competition. This concept is also closely related to classical marketing theory, which states that there are three strategic alternatives for an organization:

1. Cost leadership

2. Differentiation through product quality

3. Differentiation through customer service

Although these are very generic strategies, empirical evidence experienced during consultancy projects has shown that few MFIs have a clear understanding of the importance of this basic differentiation, and even fewer actually apply it in practice. The three strategies can be represented in the value triangle below, which is very similar to Michael Porter's generic strategies².

**Figure 3**

In general, most MFIs want to follow all three strategies simultaneously, without focusing on any particular one. This is just one of the typical errors identified by Michael Porter, who recommends that corporate strategy should focus on one of the three alternatives, but without neglecting the others. Trying to do everything right (point C in Figure 3) could mean an ambiguous and diffuse selling proposition, in contrast to the unique selling proposition recommended by specialized marketing literature.

¹ USP definition: The factor or consideration presented by a seller as the reason that one product or service is different from and better than that of the competition

² Competitive Strategy, Michael Porte, 1980
An undefined strategic position within the value triangle can represent problems for both customers and employees, and very often ends up becoming a cost driver. On the one hand, customers do not perceive any particular advantage of the products or services offered by the organization, and on the other, employees do not know what differentiates their organization from the competition. Such ambiguities have an impact both externally by reducing product attractiveness and decreasing demand, and internally on the cost structure, since striving for excellence on all competitive fronts results in a lack of coordination and a waste of resources. The USP thus acts as a guide for the decision making of all employees and ultimately results in the optimization of resource management.

Once the business model has been adjusted, product costing should be carried out again, since the original cost results were off-balance and could therefore cause a misallocation of resources. Additionally, after improving the whole business model, the new costing exercise can help with the formulation of a clear strategy that will lead to a new USP.

In short, strategic ambiguity not only causes great confusion among customers and employees by reducing demand intensity and productivity, but it also wastes resources. Thus, the USP can work as a guide for everyday decision making and for appropriate resource assignment. The alignment of business model components and capabilities with the overall strategic direction can represent greater cost reductions than the one provided by product costing itself.

Key Messages:

1. Highly competitive markets with decreasing interest rates require a reliable product costing system based on ABC methodology.

2. Not all cost deviations can be traced back to processes or best practice problems. The strategy and the business model as a whole should also be considered through a systemic approach.

3. A product costing exercise and its implicit goal of cost reduction can lead to refocusing the strategy and to redesigning the business model.

4. Ambiguous strategic positioning will have an impact on the cost structure due to the misallocation of resources to different competitive fronts.

5. To avoid poor investment or disinvestment decisions, the costing exercise should be carried out again, once processes, best practices and the business model have been adjusted.

6. Accurate information on product costing can help to determine a USP based on differentiated strategies.

7. Cost reductions start up with ABC analysis and may end up in the redefinition of business model and strategy.
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