DOES IT ALWAYS MAKE SENSE TO SHARE? COSTING IN A SHARED SERVICES ENVIRONMENT

TONY ADKINS AND BOB MISCH

TONY ADKINS is a principle product manager at SAS Institute and has worked with cost management support and delivery for more than 18 years. Mr. Adkins was a 2014 recipient of CAM-I's Robert A. Bonsack Award for Distinguished Contribution in the Advancement of Cost Management. He is a graduate of Washington State University and the author of Case Studies in Performance Management: A Guide from the Experts.

BOB MISCH is a managing director in Grant Thornton's Global Public Sector (GPS) practice and has more than 20 years of experience in solution delivery and leading cross-functional teams. Mr. Misch was the 2009 recipient of CAM-I's Robert A. Bonsack Award for Distinguished Contribution in the Advancement of Cost Management. A graduate of the U.S. Naval Academy, Bob served on active duty as a Navy Supply Corps Officer.

This article examines the application of managerial cost accounting methodologies in order to shed light on the true costs of providing shared services.

Are the shared service chargebacks to my business unit's cost centers accurate and transparent? Will I save any money by using a centralized shared service? Why should I consider a centralized shared service? These are all good questions. To answer these questions, there is a fundamental need to understand your organization's cost structure. That brings us to the age-old debate: Is traditional cost accounting sufficient to provide insight into what things cost and why they cost what they do? The answers to these questions lie in the ability to understand the root cause of cost as well as the cause-and-effect relationship of resources to outputs.

Many organizations today are exploring options to optimize services, particularly support (or back-office) services by addressing root causes of inefficiencies, including resource-sharing constraints and poorly aligned processes and supporting systems. Many believe these improvements can be realized through the implementation of shared service centers. Shared service centers are complex operations that require a new way of planning; they depend on consumers being willing to "give up control" of key support functions and rely on dependable methodologies and systems for tracking costs as well as enabling accurate, transparent chargeback rates. Intuitively, the consolidation of support services should improve efficiency, eliminate redundancy and duplication, and reduce operating costs, thus generating a return on the investment to consolidate. But how do you know this? This article examines the application of managerial cost accounting methodologies in order to shed light on the true costs of providing shared services.

Causality cost modeling (activity-based costing)

There has been a great deal published on this topic since the late '80s, but have organizations really come to believe that this is the best method to fully understand an organization's cost? "Activities are the very core of what a business does." **1** Even before Robert Kaplan and Robin Cooper proved that companies "were not gaining a competitive advantage with cost systems designed for a simpler technological age," organizations were beginning to understand that cost models were designed to show how activities consume costs in an organization. **2** This has been supported many times over by CAM-I, a recognized leader in cost, process, and performance management that has led the charge for understanding cost for more than four decades.

Activity-based costing review

Terminology.

An activity-based cost model has the following main elements: resources, activities, cost objects, and cost drivers. In addition to these elements, there are also two main types of activity-based cost models: the cost breakdown (push) and cost re-composition (pull) methods.

Resources are all expenses incurred by the organization. This information is usually found in the general ledger (GL). Budgeted data can also be used, depending on the quality and relevance.

Activities include work performed to convert inputs into outputs requiring labor, technology, raw materials, methods, or the environment to achieve an objective (goods or services of a determined category).

A cost object is the end result of an accumulation of costs. As a general rule, a cost object is the result (output) of an activity that is currently in progress (products/services in progress) or completed.

Derived from the verb "to drive," a cost driver is defined as being the consequence of an event. It is a measurable factor used to assign costs to activities, thereby indirectly attributing them to other costs, products, or services. Cost drivers reflect the consumption of resources by activities and the consumption of activities by other activities, products, or services. A cost driver is the consequence of an activity or the reason that an activity exists. Cost drivers are defined according to the particularities of the business, as are activities and cost objects.

These cost drivers are found throughout the model and are used to establish the relationships between one or more elements within the model. For example, you can allocate the costs of an activity directly to a cost object or assign those costs to other activities.

Activity-based costing methods.

The cost breakdown method (push model) consists of the breakdown (or distribution) of general ledger auxiliary account costs among various activities, based on the cost drivers of "primary" costs, followed by the direct allocation of the costs of these activities to cost objects (products or services) using the cost drivers of "secondary" costs. This method has advantages and disadvantages.

Some of the advantages of the push model are that it:

- integrates easily with the general ledger and
- is relatively simple to develop.

Some of the disadvantages of the push model are that it:

- does not always take operational relationships between the activities into account;
- is not very flexible with respect to performing simulations; and
- is difficult to integrate with operating parameters.

The cost re-composition method (pull model) attempts to reflect the flow of costs within a business. It is also known as demand-driven cost management. It is the opposite of the cost breakdown method, which only foresees allocating cost from the resources to the activities and to the cost objects. Contrary to the push method, this model is very dynamic and allows you to perform a multitude of simulations using the many elements that constitute a model. A pull model can be one level or multilevel, depending on how you want to address the organization's process flow and the impact between the activities. Nevertheless, as with the push method, this method also has its advantages and disadvantages.

Some advantages of the pull model are that it:

- models the true operating situation more accurately;

- informs capacity analysis;
- allows the inclusion of purely operational parameters;
- is more useful for the development of simulations;
- takes operational relationships between activities into account; and
- is effective for use with planning and budgeting.

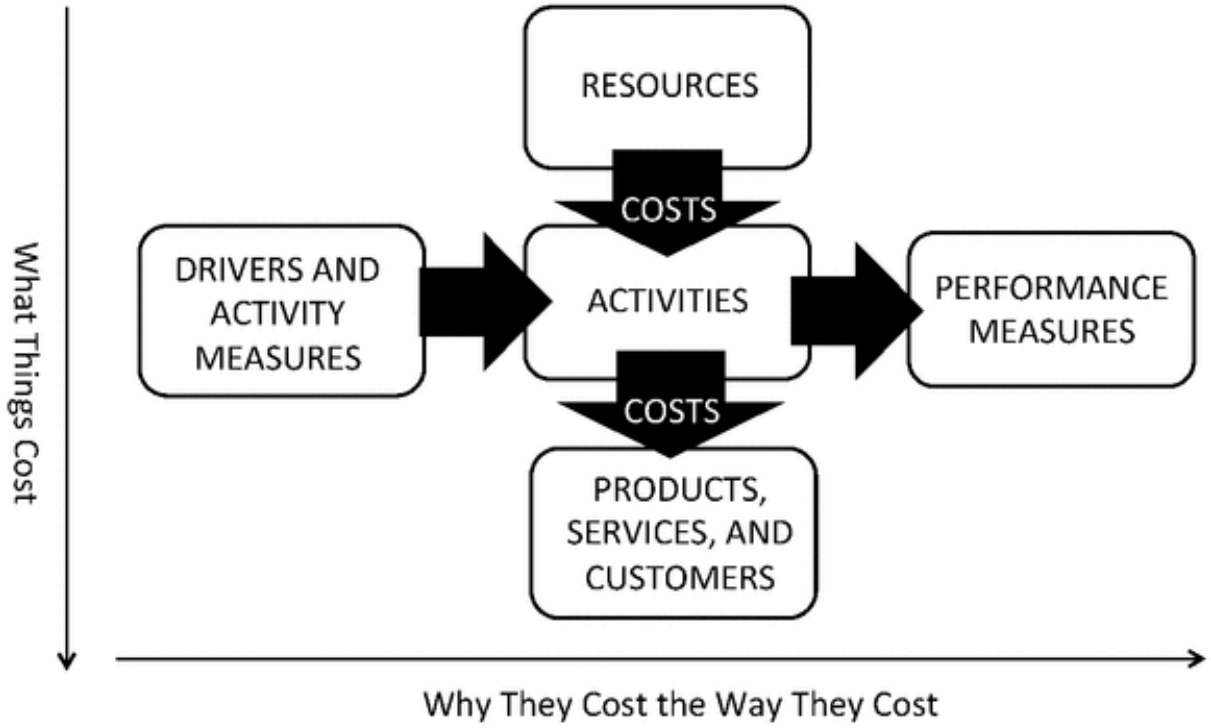
The main disadvantage is that it is more complex and time-consuming to develop.

Mixing concepts: Activity-based management and the CAM-I Cross

The relationship between the activity-based costing (ABC) push and pull models is depicted on the vertical axis of Exhibit 1, which is commonly referred to as the CAM-I Cross. While ABC (vertical) focuses on assigning resources to activities and activities to cost objects, activity-based management (ABM) (horizontal) decomposes a business process model into activities and then into performance measures. The nickname ABC/M (activity-based costing/management) is used to identify the full scope of both ABC and ABM, which incorporates the horizontal axis to help identify cost drivers and performance measures. This view has enabled cost models to evolve to become management decision-making tools, rather than just costing tools.

Exhibit 1.

CAM-I Cross: What Things Cost and Why They Cost the Way They Cost



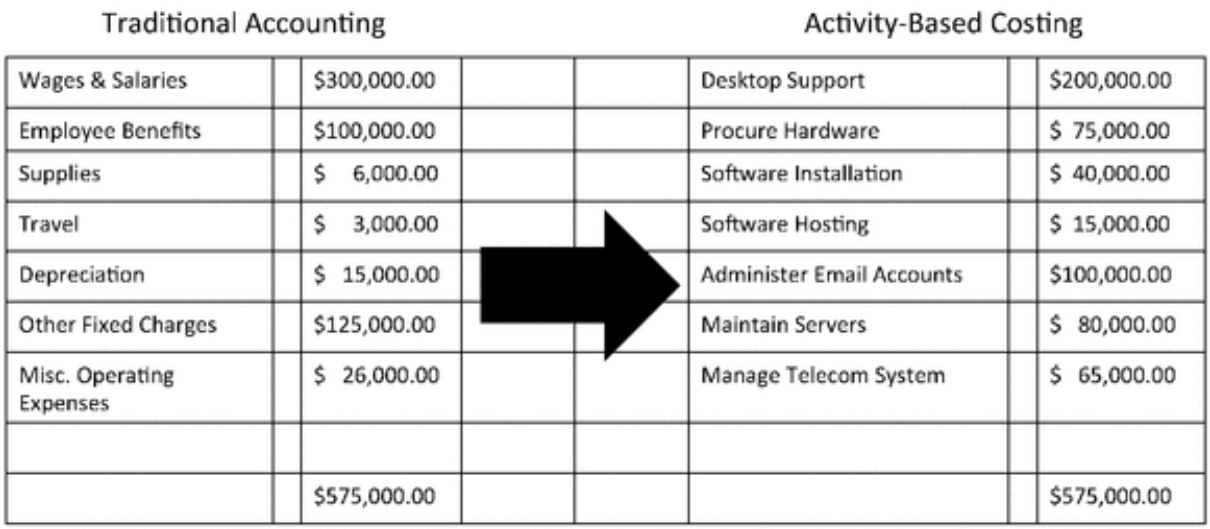
Source: The CAM-I ABCM Model, AKA The CAM-I Cross (CAM-I, 1990)

Traditional accounting versus ABC

The age-old question is, "Why isn't the method of allocation my organization uses sufficient for charging costs to the business units?" The answer, not surprisingly, is the same as why an organization should utilize an ABC model. It is because traditional accounting lacks visibility into costs. Costs are either allocated based on some arbitrary method or they are assigned based on inaccurate drivers. When costs are properly allocated based on the deserved share of costs using actual consumption of the services in question, it's easier to justify and is more transparent to an organization. See Exhibit 2.

Exhibit 2.

Traditional Accounting vs. Activity-Based Costing



Inevitably when an organization decides that it is going to charge shared service costs such as information technology (IT), procurement, or human resources (HR) back to business units, the unit receiving the costs asks, "Are they fair and based on reality?" It is not unusual that the business units getting hit with charges believe that it is incorrect or do not understand the method behind the calculation of the charges. By using a comprehensive cause-and-effect cost model that presents costs in a way in which they are actually consumed rather than an arbitrary volume-based traditional account methodology, those discussions become limited, and in the end, the charges are usually accepted.

ABC/M in the shared services environment

Understanding the cost to perform the organization's activities (and the root causes behind these costs) allows business managers to begin looking into consolidating common services across the entire organization and eliminating departmental process redundancies. By shifting the workload out of individual business units and into a consolidated center responsible for servicing the functional needs of the organization, cost reductions can be achieved. Consolidating these services can even create a cost improvement for some of these shared support services by eliminating redundancy and leveraging economies of scale. The key to success is ensuring that services are maintained at a level acceptable to the customers during and after the transition to the shared service environment.

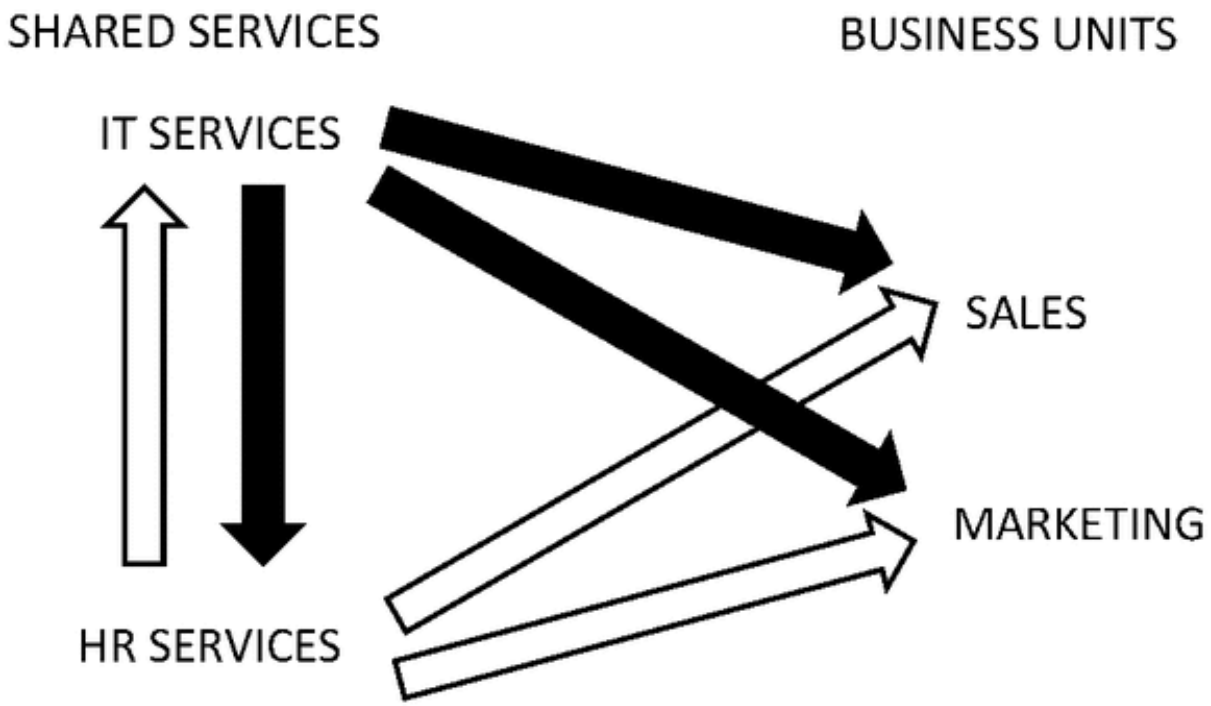
Properly evaluating this change requires insight into the service's cost, how it relates to the business unit(s), and whether it has any impact on product or customer profitability. However, organizations often do not have this insight into what things cost and why they cost the way they cost. Whether the shared services are provided in-house, by a centralized group within a larger organization (like the government), or by a third party, business units and service providers will need to enhance their understanding of how these service costs relate to other functions performed across the organization. Different departmental consumption patterns are particularly important when evaluating future demands departments will place

on the shared service to support long-term IT investment planning. Using a cost management system supports this type of strategic decision-making by modeling cost consumption patterns and performance levels.

Many departments that perform back-office functions provide services to one another, and each organization's costs are assigned to each other. This reciprocal costing is one of the most feared issues to tackle with a full absorption model (push methodology); however, any costing solution must account for these reciprocal costs without double-counting the costs when reporting them. Most commercial ABC systems will account for this, but beware when creating an in-house system, as these costs can sometimes be double-counted. It is important to be able to explain reciprocal costs and to be transparent about how they are passed between departments. For an example of reciprocal cost, see Exhibit 3.

Exhibit 3.

Reciprocal Cost Example



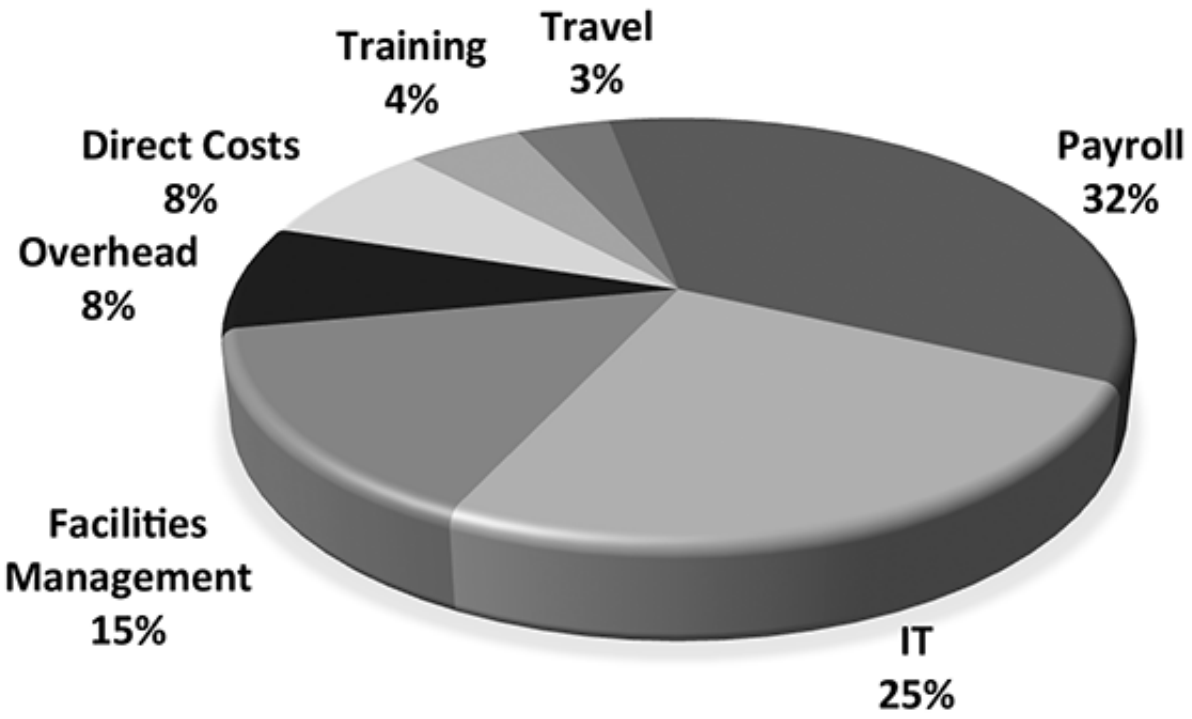
It goes without saying that whatever method is used, it must capture and incorporate the costs from other departments that are incurred during the execution of shared services. These costs may include, but are not limited to, facilities costs, recruitments costs, payroll costs, etc.

Cost savings for shared services?

Exhibit 4 depicts a typical cost center for a European bank that provides a comprehensive range of products and services to more than 3.6 million customers. The majority of the costs allocated to this cost center are directly from departments that are either overhead or from shared departments.

Exhibit 4.

Cost Center Breakout



If you asked most managers where they would cut costs first, many would simply say that they'd eliminate 10 percent from direct costs or cut training and travel. This approach of looking directly at resources instead of how the resources are utilized is typically the easy way out, as the consequence of this cost reduction is well known from past experience. However, as a manager of an organization, a key objective is to ensure your resources are deployed in the most efficient and effective way. There may be other departments or functions that are using resources less effectively, and cost reductions across these functions would have less of an impact on the organization. Understanding and examining the costs of the shared services provides insight into how effectively your resources are being deployed across functions performed and gives the best options for cost savings.

Many managers focus on reduction of cost (through outsourcing and shared services) when managing their support functions and overlook the relationship between these shared service centers and the business units they support. As a result, the budgeting efforts are not aligned, and support functions

often do not have the resources required to perform their work. Using ABC/M to calculate cross-charges and to understand the relationships between the shared service centers and the business units they support allows managers to more accurately and continually reforecast future resources needed to support their business.

Organizations typically fall into one of four levels of chargeback maturity.

- Traditional accounts on a designated target such as volume, revenue, or headcount. This approach does not reflect actual consumption but will typically take into account all costs. This method will typically penalize very profitable, high-volume organizations, and undercharge small organizations with very diverse and complex work.
- Total costs of specific items are assigned and charged back to the business unit. This also does not reflect actual business unit consumption. The difference is that it does attempt to put costs where they are incurred but still ignores the true cost associated with consumption.
- Assign costs based on a specific project or any other way ownership can be identified. Again, this is an improvement due to the fact that resource utilization by specific areas can be identified. The downfall here is that the improved reflection of costs incorporates a resource use, but resource requirements tend to vary over time for projects.
- Consumption-based causality modeling. As noted, business units have a much better understanding of the specific costs they incur, which can help provide ideas as to how they might control them better in the future. This model demonstrates a much better level of transparency for the charges billed to business units and provides quantifiable information on usage.

Consider a small bank in Luxembourg that provides a wide range of products and services for personal, professional, and public sector organizations. The organization's chief accountant recognized the need to develop a better understanding of how individual products were incurring costs from the IT and HR organization. To provide reliable costing information, it became clear that traditional costing techniques would not be sufficient. The organization employed ABC and used ABC data to accurately assign IT, HR, and all shared services to the individual business units based on how each unit consumed them (based on activities).

The result is a much better understanding of the cost of shared services and a reduction of costs over their old allocation method. In the five months following the first phase of adopting an ABC model to charge for shared services, there is a greater understanding of the services provided by the shared service center. Detailed invoices can be produced showing the business unit's use of the service, the unit price, and the total cross-charge.

Understanding capacity

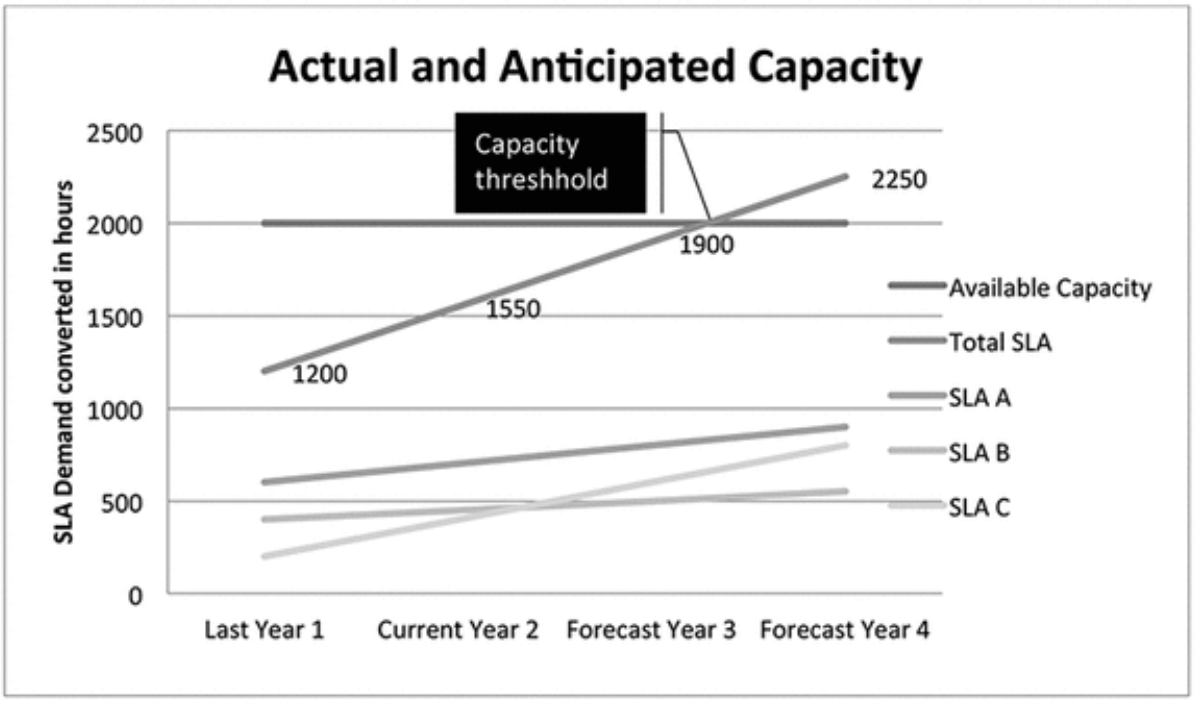
If you don't charge your service properly or your charging method is not properly defined, your customers will most likely keep consuming IT services without questioning it. By doing so, demand will keep increasing, IT services will struggle more and more to keep up, and the cost will keep increasing. The ability to provide the service-level demand for shared services is just like a manufacturing company - if you do not take into consideration the operational constraint of your organization, your unit cost is most likely wrong. So here comes the strong part of ABC/M - it provides capacity evaluation and shows how you can influence the behavior of your internal and even external customers' demand.

Capacity issue and customer behavioral impact

In the example in Exhibit 5, we assume that over the years demand kept increasing and the service-level agreement (SLA) mix kept moving toward the higher-end service. This had a tremendous impact on the organization's back office. Two decisions can be made: either increase the available resources or try to influence the demand toward different SLAs. In some cases, you might want to increase the level of resources - if and only if you can benefit from it. Therefore, you need to ask yourself if the price tag associated with each SLA is right. If it's not, you will be risking considerable reduction in profit. In the event you would like to reduce your costs, you might want to influence your customers to use less of the services in order to create some available capacity. In a nutshell, if you don't know what things cost and you don't know why they cost the way they cost, you will not be able to make the proper decision.

Exhibit 5.

Shared Services Capacity



Where to go from here

Ralph Waldo Emerson says, "Shallow men believe in luck. Strong men believe in cause and effect."

If Emerson was right, knowing the cause-and-effect relationship of cost is the key to understanding an organization's business and how costs are consumed. In many organizations, when costs for shared services are charged to a business unit cost center, there is no transparency present to provide faith in its accuracy. Conversely, service providers are left guessing whether they are recovering the costs to provide the service. A robust cost model with cause-and-effect relationships provides cost center managers clarity regarding those charges and gives confidence in the charge itself.

Consider the idea of a centralized shared service for the U.S. government. How would you know true costs as a whole, or how accurate the charges are when given to the customer agency receiving the charge? Again, it's all about understanding what things cost and why they cost way they cost. **3**

1 Miller, J.A., *Implementing Activity-based Management in Daily Operations*. (New York: Wiley, 1996): 5.

2 Kaplan, R.S. and Cooper, R., *Cost & Effect: Using Integrated Cost Systems to Drive Profitability and Performance*. (Boston: Harvard Business School, 1998): 1.

3 The Cost Management special interest group has operated as an active CAM-I interest group since 2010. The group is co-chaired by Tony Adkins (SAS Institute Inc.) and Bob Misch (Grant Thornton LLP). Key contributors to the interest group and article include Christian Babbini, founder of Decimal, John Miller of Arkonis, Dan Caricato of Grant Thornton LLP, Safana Ahmed of the U.S. Patent and Trade Office, and Shiva Verma of Grant Thornton LLP.

© 2015 Thomson Reuters/Tax & Accounting. All Rights Reserved.