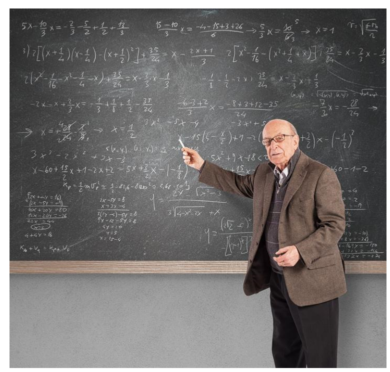
Bank Branch Accounting is Dead; Cost Accounting Systems Needed

By Mike Borland, MBA

With respect to community banks branch accounting is clearly dead, maybe it never was. We define community banks as those under $1 billion in assets and it is hard to find one that has truly implemented full blown branch accounting. As we'll discuss in further detail shortly it is a lot of work with negligible results, at least for the typical community bank. The newer factor in this whole equation is the rapid rise in other marketing and account service channels. These newer channels are being exploited by new market players, niche players if you will, and the big banks are investing big dollars into new on-line products and services. Community banks are getting in the game too, implementing solutions from their core vendor or ancillary application vendor. These new service channels are precipitating the need for cost accounting systems at community banks.



Full blown branch accounting is where you track deposits and loans by branch, assign all direct costs by branch and allocate remaining overhead to each branch. This enables management to generate a balance sheet and a P&L for each branch. It is a lot of work, although it is possible to automate some of it. The result in theory is each branch manager and his group can be appropriately rewarded for their performance, hopefully leading the whole banking group to stronger levels of performance. But numerous difficulties quickly arise, here we outline some common problems:

- Establishing ownership for customers can be difficult, what happens when a customer uses multiple branches? What happens when the customer is acquired through a new marketing channel?
- Some branches may be setup to just provide a limited level of service, e.g. no lending operations.
- Some customers are discontinuing their use of branches and using the new service channels.
- Assigning overhead costs to branches requires complex formulas and assumptions; branch managers will argue about this endlessly.
- Handling the added accounting requirements can be expensive in terms of time and effort.

After twelve (12) years of working at a community banking software provider I never witnessed even one bank fully implement branch bank accounting. But I did see multiple failed attempts, too complex, labor intensive, with results that were negligible. Too bad for me as I possess significant experience in this areai, could have been a major success in my career. Have to admit I never saw a big need for all this in the banks I worked with. But I do see a very big need for banks to do a much better job creating, analyzing, and acting on cost accounting data.

In recent times banking technology has been changing big time with all these service channels added to the equation. First we had Internet banking, then came mobile banking, with remote deposit capture thrown in there. This on top of ATM banking, possible kiosk banking solutions, and the newly developing capability of online account opening. All of a sudden bank customers could be accessing your services through all sorts of channels. Most banks, even small community banks, are offering these services. No banker wants to tell a customer or potential customer they don't offer internet and mobile banking, remote deposit capture is right up there now too.

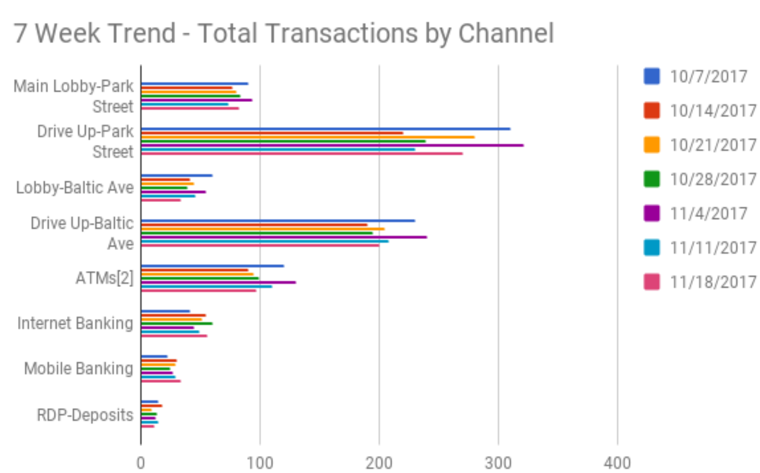
What community bankers need is first and foremost better cost accounting systems. If you looked to the manufacturing industry you'd see they do a superb job tracking and assigning costs, an entire branch of accounting is devoted to it, aka cost accounting. In this discipline understanding your fixed and variable costs aids in the analysis, also frequently described as marginal analysis. To simplify we want to be able to track our costs for running a particular service channel well enough that we have the expenditure broken out and understand the capacity (e.g. transactional volume) this system can handle. Wrapping up this basic concept here, we are going to compare our costs to the output (activity) so our productivity between channels can begin to be measured. Given that our banking system costs tend to be fixed, small increases in utilization would expect us to see costs per activity drop with growth.

In nutshell this can be summarized in a formula, as follows:

$$\frac{\text{Total Channel Costs\$}}{\text{Activity Tracking}} = \text{Cost Per Transaction}$$

Looking closely at this basic equation you can see we need the following:

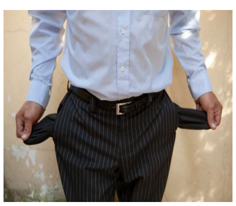
1. Cost tracking that does a good job breaking out expenses by service channel and gives us insight as to what costs are fixed and what are variable.
2. Activity by service channel data must be fully captured, activity is a definition that includes basic transaction counts but extends this definition to other services and tasks.
    a. While we're not marketing focused in this piece activity should most definitely be tracked by customer as well.



Activity Tracked by Service Channel – In order for us to better understand the value a channel is providing we need detailed activity tracked and captured. A service channel can be a branch, online internet banking, mobile banking, an ATM, or maybe even a self-service kiosk. Any time that customer uses one of these service channels, even if it is just a balance inquiry, is important data. The activity by service channel should be tracked periodically by week, month, etc. Some real time reporting is important too, this could give bank managers their first clue when a service channel is failing, hard to know that web site page or web service request is not being fulfilled. This is a good test of your activity reports as they should show if problems develop, e.g., your bank usually sees 75 deposits a week thru remote deposit capture and the number drops down to 10 one week. Customers are not going to tolerate a service channel failing, especially once they have gotten accustomed to using that newer service. Waiting until the customers complain is not a good proactive policy, track it as proactively as you can.

Activity Tracked by Customer – Good activity tracking, where possible, should always be tracked by customer too, when analyzed and reported by customer you have what I would call marketing reports. You want to know how your customers are utilizing your services, whether thru online web banking, an existing branch, or maybe thru your new mobile banking application. It would be super cool to be able to see how often a given customer was accessing banking services by just pulling up their CIF screen in the core, e.g. Joe signed into his online banking account 7 times, opened the mobile banking application 10 times, and visited our Baltic branch 2 times in the last 30 days. Of course we want to know how many transfers you make online, if you are making deposits via Remote Deposit Capture, and how often you use your debit card. This data would feed into statistics that would allow you to profile your new customers and recently lost customers. None of this should be super complicated, big data not necessary. But it does usually involve relating data from disparate systems.

So how are these investments performing? What are your bank's costs in terms of capital investments and annual operating costs to operate these newer channels? With basic cost accounting in place we can track direct costs to implementing and maintaining these new channels, giving us the capability to compare the efficiency and effectiveness of one channel versus another. With a smaller bank this may be as simple as setting up and breaking the costs out to a new GL expense accountii. If not done at the outset accounting personnel can go back through the contracts and expense records and make adjustments (or least obtain the numbers) for the last couple of years to give you a base for evaluation. This will also be quite valuable when you go to re-negotiate the deal with the vendor or look to move to a new solution.



Operating Reports – These are the reports that would compare your cost information to run a channel, ideally broken out by fixed and variable, against all those activity numbers you have on a given service channel. With the cost information in hand and good statistics on the activity of this channel you can evaluate the relative success or failure of your investment. Future investments and banking strategy can be better devised. The level of report sophistication here can vary considerably, smaller banks will want to keep it simpler. But every single community bank should make sure they are tracking some basic data (costs and activity) on their channels and have this capability. Otherwise you will be operating and making long term decisions blindly.

Successful community banks pursue a lot of different strategies, much more varied then you might imagine. But one common trait the consistently higher performers exhibit, both in terms of growth and profitability, is they operate very efficiently. You can see this directly in their bank efficiency ratio and in their non-interest expense levels relative to average assets. Managing and making the right long-term decisions requires good information. And good information is much harder to come by with the newer technology developments, i.e. we don't have peer group data broken out for these new systems. In the high-tech and fintech worlds amazing economies of scale are being demonstrated and community banks should be realizing some benefit here too. If you have been successful your ratios will superior to the industry averages.

The world is not going to stand still and you have to be prepared to make changes in response. New technology is obviously becoming quite disruptive, we can all see that. For the most part community banking so far seems to have remained immune, but these days are likely numbered. Many community banks have done an outstanding job of establishing a solid relationship with their local community and can expect a high level of loyalty. But what happens when those customers are offered a fully insured online money market account several full percentage points above the .25% your bank is offering, what happens when your customers can get a mortgage in less than half the time and effort you're able to provide. In order to compete you have got to be effective and efficient.

I think we are clearly moving to a whole new model, one that is going to demand robust cost accounting. Cost accounting requires sound activity tracking across the new channels used for marketing and service. The good news (really good news) for community banks is this does not have to be unwieldy and complex. You can start small and build this capability, time is still on your side. Sure it will eventually get complex as you get bigger and the channels mature. 1) Make sure first off that you are trapping the data you're going to need. 2) Begin analyzing the data, don't wait for some third party solution provider to do this for you. 3) Identify gaps and shortcomings is this area and look for solutions. Remember if you own the solution your bank can gain a competitive advantage.

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[i] In my career I have analyzed and reorganized half a dozen companies GL schemes to improve reporting. At a non-bank financial services firm, I implemented departmental accounting, including P/L capability by department, the rough equivalent of branch bank accounting.

[ii] Unfortunately, most banks GL account schemes and implementations were not designed with this specific end analysis in mind. Worse yet they have evolved over the years into a mess, interspersed with obsolete accounts and even used to track inappropriate level of detail that should have been left in a subsidiary schedule or system.

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