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# Cost of Maintaining Depositors' Accounts*

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The subject of costs is usually considered from a technical point of view and any discussion is, therefore, apt to lead into depths far beyond the ability of the average man to comprehend. Fortunately, it does not seem necessary to reach those heights or depths in a paper such as this. If we can arrive at a clear understanding of the basic meaning of costs and their application to the business of running a bank, we shall have accomplished something.

Cost accounting is usually associated with manufacturing. As a matter of fact, few businesses do not, to some degree, harbor the element of cost in relation to the income of that business. For instance, the wholesaler or retailer, if he is to know which lines or departments yield an adequate profit, must resort to costs. In a particular department yielding a gross profit of, say, 25%, some articles may be priced to yield as high as 40% or 50%, whereas others may yield a gross profit of only 15% to 20%. Even the professional man must base his fees with some regard to the cost. A dentist, valuing his services at $10,000 per annum, must resolve that sum into so much per working minute. If he is a prudent dentist he will do the same with the salary of his assistants, rent, telephone, supplies, depreciation of equipment, etc. By adding these two amounts he has a basic cost per minute and, therefore, a basis for his charge to patients with almost a certainty as to net income, provided his preliminary estimate of working minutes in the year is correct.

The basic elements entering into costs consist of material, labor and overhead, or burden as it is sometimes called. There are varying methods of allocating these three elements against the unit for which the cost is desired. The ratios of each element to the other two will vary widely in different lines of industry. In some branches of manufacturing the basis for allocating these three elements to the article for which a cost is desired may be quite complicated and in others simplicity itself.

The development of correct accounting procedure is a slow educational process. The tendency is to rely on more or less

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haphazard information or intuition as to results to be accomplished. This is probably due to the fact that most business men are essentially manufacturers or salesmen. They are primarily interested in making or selling something. The keeping of records is a necessary evil.

Edward N. Hurley, chairman of the federal trade commission in 1916, who did a great deal to develop the idea of better accounting and cost methods among manufacturers, said:

> **An amazing number of manufacturers, particularly the smaller ones, have no adequate system for determining their costs and price their goods arbitrarily. It is evident that there must be improvement in this direction before competition can be placed upon a sound economic basis.**

We are prone to look only at the net result and ignore many of the steps leading up to that result. This is especially true if a fairly satisfactory net profit is realized. However, in the present highly developed state of industry, largely as a result of the impetus given to business during the past ten years, it behooves everyone, be he manufacturer, wholesaler, retailer, banker or professional, to set his house in order and provide some means whereby he can follow the trend of his business with a view to strengthening some features and eliminating others entirely.

The banker has something for sale just as truly as the manufacturer. It is admitted that that something consists mainly of services, but it is essential that he should know the cost of those services in order that unprofitable business may be eliminated or made profitable.

As W. H. Kniffin says in his book, *Practical Work of a Bank:*

> Bankers are no longer satisfied to know that they have made a profit—they want to know where the profit came from and how it arose. It is needful that the sources of profit be known in order that the sources of loss be also known. . . . Aside from lending money the bank renders the following service to its depositors: Receives his funds—money, cheques and other instruments of credit on deposit and for collection. The money it keeps safely; the other items it turns into money sometimes without cost. It furnishes him with a cheque book and pass book, free; pays his cheques as he directs; returns the receipted vouchers with a statement rendered; often makes up his payroll; furnishes money in such form as is requested; guarantees that the party to whom the cheque is payable has received the money; and warrants not to pay on forged orders.

If one stops to think what may be the consequences where trustworthy data are unobtainable through lack of an adequate system of accounting, it will be appreciated how necessary it is to any business to have this information. On the other hand, there are many concerns which are relying today on totally inadequate records for the conduct of their business. How many times have bankers preached better accounting methods to customers. Indeed, the accounting profession is very grateful to the banker for the work he has done in developing the field of accounting. Of course, the banker has not been altogether unselfish in this endeavor, as it was greatly to the interest of the bank that its customers keep careful books of account, showing the correct financial status, and maintain some adequate method for ascertaining the cost of doing business. As the customers of a bank prosper and are successful year after year in their business, so only can the bank hope to prosper and keep solvent.

What I am about to say now may appear to come with poor grace as the guest of bankers, but when I recall the many times I have listened to bankers' harangues to the accountant on his shortcomings I may be permitted to make a few observations.

Like the proverbial shoemaker who mended everyone's shoes but those of his own children, I believe it is a fact that, as a class, bankers maintain for their own banks the most inadequate and unscientific systems of accounting that will be found in any branch of industry. This condition is probably due to several causes:

1. Tradition or custom as to general procedure surrounding the banking business;
2. Low salaries paid to bookkeepers and clerks;
3. Non-technical training as accountants on part of officers and clerks;
4. Apparent ignorance of the accounting profession as to routine work in the operation of a bank.

I do not mean to infer that the banking situation in this respect is hopeless. In fact the interest indicated in this question of costs shows, at least, that bankers appreciate that something is missing in the banks' system of accounting. In looking up the available data on this subject of costs it developed that reams of valuable matter have been written and this subject has been discussed at many meetings. Banks have been adopting modern appliances such as bookkeeping machines, addressographs, telautographs, etc., to simplify the procedure and provide a means of overcoming the ever-increasing mass of detail incident to the operation of a modern bank. In the same bank, however, where one will find all these modern appliances, as well as the monthly statement, it will not be uncommon to find:

1. All income and expenses recorded on a strictly cash basis without any statement as to the real income earned or expenses incurred for the period under review;
2. No classification of income or expenses or, if classification is attempted, on so unscientific a basis as to be of little value in a study of the bank's operations;
3. No attempt to allocate income and expenses departmentally for the purpose of determining the efficiency of department heads;
4. The most inadequate method, if any, for determining whether or not the accounts kept by the depositors of the bank are maintained on a profitable basis.

If it is important for the manufacturer or the merchant to maintain an adequate system of accounts to ascertain if any department of his business is being operated at a loss, why is it not just as important for the banker also to do this? There may be some slight excuse for this omission if one is conducting a bank solely on a service basis without regard to dividends to stockholders. I say "slight excuse" advisedly, for, even if banking were conducted on so philanthropic a basis, there would still be the necessity of treating all depositors fairly. It will be conceded, as between two depositors maintaining daily balances apparently of equal amounts, if it could be demonstrated with reasonable accuracy that on one account the bank realized a monthly profit of $100 whereas on the other there was a loss of $100, an injustice was being done, assuming, of course, that we can disregard what might be termed indirect benefits, difficult of valuation, accruing to depositors and stockholders alike.

Few banks, however, are operated on so altruistic a basis that profits can be utterly ignored. In fact, it has been my experience that profits are a most important factor in the development of a successful bank. If that is so, why should not the banker, who is generally looked upon in the community as the source of sound advice, be the first to adopt those methods which he himself believes necessary in a well conducted business?

Are bankers afraid to face the knowledge that the account kept by Mr. Jones is costing the bank several hundred dollars per annum more than is earned on the balance which he condescends to leave in the bank, or are they afraid that if they speak to

Mr. Jones about this condition he may take his account across the street to a competitor? Are bankers very much concerned if he does relieve them of a losing account? Does it not resolve itself strictly into a selling proposition at this point?

A. P. Howard, in his article on *How to Determine the Cost of Accounts in Small Banks or Trust Companies*, has said:

> Human psychology enters into the discussion. Some customers will leave you no matter what your arguments may be. They will not understand you. This state of mind cannot be avoided, but is it not better to lose a profitless account rather than maintain it because of the unreasonable attitude of an individual depositor? It is true that he may tell others about the treatment received and the collateral influence may do your bank some harm. The only answer is that all education and enlightenment is a slow process but invariably it works for the benefit of all. It is the basis of human progress, public education, and is the cornerstone of our form of government. Fear of the results of education and enlightenment can only lead backward.

What would one say to a customer of the bank if he reported that he was losing $2.00 on every pair of a certain style of shoe? The first question would undoubtedly be: How much of that $2.00 loss represented overhead and how much was actual labor and material? The next question would be: How necessary was this particular style of shoe to sales of the profitable styles? On his answers to these two questions would depend the advice as to continuance or discontinuance. I am assuming, of course, that the shoe manufacturer has a good cost system and that he has exhausted every effort to reduce the cost of this particular style of shoe.

While there undoubtedly has been a great deal of interest manifested in recent years by bankers on this question of the cost of maintaining a deposit account, I doubt if many banks make more than a pretense at seeking a solution of this particular problem in their institution. A great deal has been written on the subject, but apparently the thought has been that only the large banks could afford to go to the expense of ascertaining this cost. Until all banks, big and little, realize that costs are an essential part of their regular system, the full benefit to be derived from such a study will not be felt.

How many older bankers remember the day, not so many years ago, when, in fear and trepidation, you asked a prospective borrower for a statement of his financial condition as a basis for a decision on his application? Today if a borrower is not asked to submit such a statement at least once a year, duly certified to by a firm of certified public accountants acceptable to the bank, he feels slighted. You have no fear that he will become irritated by such a request and take his account across the street, because you feel morally sure that your friend Mr. X will ask him the same question.

That, I believe, is approximately the condition you can create with regard to this question of cost of maintaining a depositor's account. True, there will be a degree of variation as between two or more banks in the total cost or net profit for the same account, but a large part of the cost will be so similar that great good should accrue to the banking community by the ultimate unanimous adoption of some more or less recognized basis for ascertaining costs. This can only be accomplished by education. You, yourselves, must be thoroughly convinced of the necessity, then you must sell the idea to your neighbor who may be less willing to see the light.

If the question of costs is fundamental and if it is conceded that cost does enter into every transaction in which there is hope of profit, then surely there can be no argument as to the propriety of costs in the banking business. *Webster's Dictionary* defines cost as

> The amount paid, charged or engaged to be paid for anything bought or taken in barter; charge; expense; hence, whatever, as labor, self denial, suffering, etc., is requisite to secure benefit.

It will be agreed that there is much labor and self denial even if there is little actual suffering in the maintenance of friendly relations with the depositors of your respective institutions.

This relation of bank and depositor is decidedly two-sided, and unless an equitable arrangement is entered into the association cannot endure successfully. For the depositor, the bank acts as his agent in receiving and collecting deposits, by cashing on demand cheques which the depositor draws on the funds so deposited with the bank, by safeguarding those funds, by an allowance for interest and numerous other special services. In return for this the bank, by investing the funds of its depositors, hopes to make more in income than the cost of all these services enumerated above.

An intelligent cost analysis of a depositor's account will disclose whether or not the bank has realized a profit, or whether the account has actually cost the bank money to maintain. The adoption, generally, of a plan of cost analysis should protect not only the bank but the public as well against injudicious competition. No competition is quite so disastrous or difficult to combat as that based upon ignorance.

These benefits will be measured not only by an improvement in the relations with your depositors, but, with the exchange of information between banks as to unit costs of doing particular kinds of business, more efficient organizations will be developed and costs of doing business will be reduced.

Probably the bank's simplest remedy for an unfavorable situation disclosed by the cost analysis will be an adjustment of the rate of interest or of the amount of the free balance to be maintained by the depositor. It may be possible to induce the depositor to increase his average balance or make a more equitable distribution of out-of-town items as between his several bank accounts.

It is my belief that most people want to be just in their business relations with their fellowmen. If, as a result of a cost system worked out with some care, taking into consideration the size of the institution involved, it develops that an account can be shown to be on an unprofitable basis, a frank disclosure of the facts by the bank will result in some equitable arrangement to correct the condition.

In this discussion with the depositor, the banker must start off with a few clearly demonstrable facts before he launches into such abstract and debatable factors as the cost of handling an item or the overhead applicable. In many cases he will not reach those two factors before he has convinced his man that an adjustment is necessary. It should not be difficult to show that it costs something to lend money at 6% so that the actual rate earned is below that figure. There will be a little trouble in convincing him that instead of a daily average balance of $2,750, as shown by his books, the bank really had available for investment only $1,000. That will be difficult, but if the banker is a good salesman and knows his business he ought to be able to prove his case. The matter of the cash reserve and the interest paid the depositor on his account are simple facts.

I am also of the opinion that any sum of money within reasonable limits expended for the installation and maintenance of a cost-analysis department suited to the requirements of the particular bank will be a worth-while expenditure and produce dividends for the bank. It would, of course, be ridiculous to expect a small country bank to adopt a cost system in the same detail as would be desirable in the large city bank. However, a system based upon certain fundamentals can be devised to fit both the large and the small bank. The only difference need be the degree of fineness or extent to which the analysis shall be carried.

Such a system would appear to have been devised by the federal reserve bank of New York under the title *Analysis of Depositors' Accounts—Short Method.* Numerous other systems have been studied, but for simplicity and general practicability, this scheme appears well adapted to the needs.

Inasmuch as "activity" is the principal factor of cost, it follows that the bulk of the expense applicable to a depositor's account will be allocated to the account on the basis of the number of items deposited and charged. It is also fundamental that amounts in transit should be eliminated from the daily basis before crediting the account with its proportion of the income from loans and investments.

If the bank desires greater accuracy in its costs, it would do well to heed the advice in this federal reserve pamphlet with regard to subdivision of the items into classes such as city, clearing house, country, etc., for the purpose of ascertaining the cost of the various kinds of items. It will be obvious that an out-of-town item will cost more to handle than a clearing-house or city item.

The apportionment of expenses on an equitable basis to the various departments undoubtedly presents the most difficult problem. However, a little care in this respect should result in a segregation as between expenses applicable to deposits and expenses not so applicable. For instance, no part of the expenses of safe-deposit, trust or foreign departments should be used in determining cost of depositors' accounts. Another point to bear in mind is that certain expenses will form a primary group and others a secondary group. The result, after deduction of the first group, may be termed gross profit and, after the second group, net profit.

In any cost system there will be found a group of expenses known as overhead or burden, spread over the cost of the article manufactured on the basis of direct labor, material consumed, or perhaps both combined. This plan also provides for such a group spread partly on the basis of the number of deposit accounts and partly on the basis of size of deposit. Perhaps size is the least justifiable base and any large apportionment in that class should be discouraged.

In conclusion it would appear that some method of cost analysis is as essential for the banker as for the manufacturer or merchant; that the general adoption of the scheme is dependent upon an educational process which bankers themselves must conduct; that the benefits both to banks and the public, generally, will be well worth the effort expended; and that there is now in this federal-reserve plan a workable system which can be expanded or even contracted to fit each particular situation.