Counting your costs

Ted Prince is senior vice president of Optimization Alternatives Ltd. He can be reached at (804) 754-2291, or via e-mail at ted@oax.com.

There must be smiles all around at SAP headquarters in Walldorf, Germany. CP Ships attributed its recent discovery of $41 million in previously unrecognized expenses to the implementation of a new SAP financial accounting system. In contrast, consider Nike Chairman Phil Knight’s 1991 comment, “This is what we get of our $400 million, huh?” when Nike blamed i2 software failures for earnings shortfalls.

CP Ships claims the accounting problems are related to the complex nature of liner shipping and extensive intracompany transactions. But if CP Ships couldn’t capture cost on a company-wide basis, how does it assess costs on individual shipments, or even trade-by-trade?

It makes us wonder how prevalent such cost-accounting problems are among other steamship lines. Today, many steamship lines still manage expense using traditional vessel and voyage accounting methods of cost “buckets” (i.e., how much money was spent on a specific function.) Some lines, driven by odd logic, increase the number of cost codes to manage expense better. In truth, better management does not need more cost codes — it instead requires detailed cost information on an individual shipment basis across the global enterprise.

Costs must be specific and accurate. Liner shipping is an asset-intensive business characterized by vertical integration. As a result, calculation and allocation of its costs are often assigned arbitrarily. Part of this may be due to the fact that operating units do not carry a true cost of capital, which is managed at the parent level. In addition, liner operations may acquire feeder vessel and/or terminal–operating capacity from a related company.

Because most liner shipping companies are global multinationals, transfer costing is a common practice. Frequently, transfer prices are established to minimize tax liability, or to make certain business segments appear more (or less) profitable. True costing must overlook arbitrarily established transfer prices.

Successful companies have implemented activity-based costing (ABC) to identify exactly how activities generate the costs, which are consequently transferred to products and customers. But ABC implementation is complex, and most lines lack the detailed information needed to administer it effectively.

Some of today’s ship lines employ a system of average costs to determine shipment profitability. Twenty years ago, most manufacturing companies realized that traditional accounting systems were providing faulty cost information. By not identifying actual product cost, these systems failed the business managers who were responsible for pricing a diverse product mix to various customers. The resulting accumulation of average costs perhaps hid real customer profitability — or lack thereof.

Some lines have developed rudimentary NCTV (net contribution to vessel) programs, which can actually exacerbate cost misperceptions. For instance, such programs use system average costs — rather than specific detailed ones. As a consequence, the line may retain more of the undesirable sectors of business, while better-informed competitors solicit the more profitable pieces of business.

Strategizing based on average costs is also dangerous, because “average” costs vary by range or time. The result is that these costs constantly lag real time. This can be disastrous in a time of cost volatility. (CP Ships cited this very problem.) It is not unusual for specific vessel costs to experience seasonal cost fluctuations, due to balance, volume and mix.

Equipment-cost allocation demonstrates the dangers of average costing. Many lines fail to thoroughly track utilization, and assume that all loads share the same turnaround times. Furthermore, accessoriel revenue (which accountants might classify as an expense offset — rather than revenue) is not usually associated with the specific customer transaction. It is not enough to say that long equipment turnaround time is bad. A customer who uses equipment for storage — but pays the demurrage or per diem — may be much more profitable than a customer who turns around the equipment in a couple of days.

Equipment-repositioning expense represents a major cost. But it usually appears on the records as a transportation linehaul expense. Average costing frequently aggregates expense by geographical regions and fails to distinguish wide cost discrepancies in location, equipment size and type. The same equipment cost information issue that plagues container moves, exists for chassis and generator sets.

All transportation carriers face costing challenges. The problems are just more pronounced for liner shipping. Our industry is still enjoying favorable market conditions, but future success will surely go to the carriers who best understand their costs.