PRODUCT COSTING AND PRODUCT PRICING

FINAL REPORT

January, 2007

This publication was produced for review by the United States Agency for International Development. It was prepared by Jeff Young, consultant for Chemonics International Inc.

Rural SPEED

Rural Savings Promotion & Enhancement of Enterprise Development

PRODUCT COSTING AND PRODUCT PRICING

FINAL REPORT

Rural SPEED
A USAID funded project
Contract No. PCE-I-00-99-00003-00, TO 826

This report submitted by Chemonics International Inc. / January, 2007

TABLE OF CONTENTS

EXECUTIVE SUMMARY

Between November 25 and December 22, 2006 the consultant was engaged by USAID/Rural SPEED to train 24 SACCO management staff (8 managers and 16 loan officers) in proper pricing and costing of their savings and loan products; develop a simple manual covering key aspects of product costing and pricing; and mentor the boards and management of these same SACCOs.

Prior to arriving in Uganda, the consultant reviewed best practices in product pricing from diverse sources including MicroSave and CGAP. Upon arriving in Uganda, this literature review was discussed with Rich Pelrine, the Rural Finance Advisor, and Bob Barigye, the Rural Finance Specialist to adapt the materials into an appropriate local training regimen.

For ten days, the consultant traveled to the field, principally western Uganda, and reviewed the current practices in terms of product costing and pricing with each of Rural SPEED's eight partner SACCOs. In the initial assessment it became clear that none of the SACCOs had been trained in this skill. Some were better than others in that they had thought about product pricing and considered the need to generate adequate contribution from their assets to counter balance their savings liabilities but none of them had a formal policy or process for doing this.

The consultant then developed a manual to cover the process of setting interest rates based on determined contribution margins calculated on a product by product basis. This draft manual was reviewed by Rural SPEED's staff and served as the basis for a three day training program held in Mbarara.

The three days training was meant to cover fundamental loan yield calculation, maturity gap management, basic cost accounting and concluded with product development. The training itself fell short of the objectives as it was hindered by communicational difficulties. Participation could have been stronger. The product development module was not adequately addressed. The participants sat for a quiz following the training. The average score was 80% with lowest being 60% and the highest score being 90% demonstrating that comprehension was reasonable in spite of the communication difficulties.

Following the three days training, the consultant visited each SACCO in turn to conduct an on-site follow up to the training with the board and senior managers. The key observation in all cases is that the SACCOs are sorely lacking effective computerized MIS that can ease the complex task of cost accounting. Three SACCOs, Mamidecot, Bugongi and Kyamuhunga showed considerable human capacity to apply the cost accounting concepts but again were hindered by weak MIS. The other SACCOs will need continued support to master the concepts and particularly Shuuku and Ikongo may require in depth continuous assistance.

Upon completing the consultancy, the draft manual was finalized and submitted to USAID/Rural SPEED. The project decided to provide further additions and edits to the existing manual.

SECTION I

BACKGROUND

Introduction:

Since 1987, when the Government of Uganda (GOU) instituted major economic policy reforms, the financial sector has become increasingly efficient, productive, and competitive. Uganda is well on its way to a vibrant financial services sector, with 15 commercial banks, seven commercial credit institutions, four micro-deposit taking institutions (MDIs) (one additional license in process), and numerous microfinance institutions (MFIs) and member-owned organizations. However, despite recent growth and liberalized economic policies, only 10 percent of the rural population has access to basic financial services and the formal and informal financial sectors still require some structural changes to provide the range of financial services that individuals and businesses require. Commercial lending and the majority of microfinance activities remain confined to urban and peri-urban areas due the high cost and low return of rural outreach. In addition, interest rates remain high, adequate forms of collateral do not exist due to continuing disorganization within the land registry system, and there is little accountability of Tier 4 institutions such as savings and credit cooperative organizations (SACCOs) and savings and loan associations. To stay true to goals set in the GOU's Poverty Eradication Action Plan (PEAP) to achieve an economic growth rate of seven percent to eight percent and reduce poverty to 10 percent by 2017, all citizens, especially the poorest, must benefit from economic growth and have access to financial services.

The USAID/Uganda's 2002-2008 Strategy calls for expanded sustainable economic opportunities for rural sector growth, promoting a connection between productive strategies by the private sector in rural areas and expansion of financial services sector. Rural Savings Promotion & Enhancement of Enterprise Development (Rural SPEED) was designed to help meet this goal.

The objective of Rural SPEED is to deepen and strengthen Uganda's financial sector in response to this rural sector demand for financial services. Increased provision of financial services should leverage economic activity to complement other Mission's programs in rural areas. The resulting increase in economic activity should help Uganda achieve the economic growth rates proposed in Uganda's Poverty Eradication Action Plan (PEAP). The project is supporting and executing activities in the key areas of:

1. Institutional Capacity Building, including:
   a. Savings Mobilization;
   b. Agriculture Finance;
   c. Non-agriculture Finance;
   d. Bank/MDI/MFI/SACCO Linkages; and,

2. New Product Development and Service Delivery.

It has been established that SACCOs in Uganda rarely cost their products to determine their viability. Recent product evaluations supported by USAID/Rural SPEED confirmed that some SACCO products are loss-making. Apart from failure to determine the profitability contribution of products, SACCO knowledge about the full costs of delivering products is also lacking.

Rural SPEED trained 24 managers and loan officers in activity-based costing of their products to help them understand the constituent processes they perform as well as the costs of each process. This raised their awareness of the cost components of different products, help them make informed decisions about selection of products and facilitate pricing of current/future products. Further, Rural SPEED directly mentored eight partner organizations, through short term technical assistance and ongoing project support, in these systems.

Objective:

The intent of this assignment was to provide the eight client SACCOs with an introduction to the topics of cost accounting, product line pricing, and product development. There will be additional training building on this basic understanding (including savings product development and treasury management) to the SACCO managers in each of these areas.

The SACCO managers and their Boards of Directors needed to understand the importance of having the ability to have accurate, meaningful financial data about, not only their overall financial performance, but the ability to analyze the profitability by product line, and to have the ability to use their financial data to make informed decisions.

Methodology:

The methodology for this consultancy was provided in the Scope of Work. The purpose and tasks outlined below reflect the actual methodology and are drawn from the Scope.

Purpose:

The purpose of this SOW was to train 24 SACCO management staff (8 managers and 16 loan officers) in proper pricing and costing of their savings and loan products. This will help them gain insight into the cost structure of different products. The Consultant will also directly mentor nine SACCOs which are partnered with Rural SPEED. The consultant will also be required to write a technical manual, to be published by the project, on product costing and pricing.

Tasks:

- Meet with Rural SPEED to define the implementation schedule under the SOW
- Meet with Rural SPEED partner SACCOs individually to understand the current product pricing and costing practices.
- Develop a three day training module to cover:
- Key points of analysis for evaluating costing and pricing of savings and credit products
- Activity-based costing methods
- Allocation of costs to individual products
- Product-level viability analysis
- Strategies for increasing efficiency and viability of SACCOs in service delivery and new products development
- Deliver this training module in Mbarara for 24 participants.
- Conduct an additional one day mentoring session, based on discussion and field visits for each of Rural SPEED's eight partner SACCOs' Boards and Senior Managers (one visit to be done with each day for eight days).
- Write a product costing and pricing manual fit for publication.
- Prepare a final report reviewing the trainings, noting institutions visited, identifying critical weaknesses and making the necessary recommendations.

SECTION II

ACTIVITY SUMMARY

The consultant reviewed key materials in advance of arrival in Kampala from agencies such as MicroSave and CGAP covering cost accounting and interest rate determination for small institutions. Upon arriving in Kampala, the materials, along with the consultant's previous expertise on the topic, were discussed with USAID/Rural SPEED to develop an appropriate strategy for reviewing the existing situation with the SACCOs, developing an effective training manual and lesson plan and delivering meaningful field level mentoring.

The consultant spent ten days in the western Uganda reviewing the understanding and procedures around cost accounting and product pricing as practiced by Rural SPEED's eight partner SACCOs. The following summarized specific observations were made:

MAMIDECOT:

All loan products were priced at 2.5% flat without consideration of product management costs and/or product contribution margin. Beyond the interest rate, the loans also earn a 2% arrangement fee. Interest rates are set by the board on savings products, also without consideration of contribution margin or management costs. Currently savings products pay 2% annually to the depositor.

Shuuku:

Shuuku also priced all varieties of loans at the same interest rate which was 2.5%/month on the declining balance. Loans are not differentiated based on their contribution margins but agricultural loans and motorcycle loans were repayable over two years. All others were payable in one year. Shuuku also charges a 2% loan commitment fee. The interest rate on savings is set by the board and is 3% annually.

Muhame:

Muhame charges 3%/month on the declining balance on all of their loans. The maximum loan period is 9 months. Muhame also has a one day loan product for which they charge 1%/day. This product was developed with USAID/Rural SPEED and takes into account cost coverage. Muhame pays 0.5%/monthly on savings deposits and 1%/monthly on fixed deposits. The balance of liabilities to assets is not scientifically managed.

Kitagata:

Kitagata charges 3%/monthly on the declining balance on all of their loan products. They further charge a 3% commitment fee on each loan. Loan products are differentiated only by term. School fees products are payable in 3 months, all others are payable between 1 and 24 months. Salary loans also carry a three month grace period (which may be irrational). Salary loans cannot exceed 12 months and agricultural loans cannot exceed 24 months. Kitagata pays 6% annually on savings. Again, there is no scientific method employed to cost or price any of these products.

Bugongi:

All of Bugongi's loans are charged 3% monthly on the declining balance. Like other SACCOs the differentiation in loan products is based on term. School fees are repayable in 3 months, motorcycles in 12 months, solar in 24 months with a 3 month grace period, commercial in 8 to 12 months. Other loan income comes from various types of fees. Bugongi pays no interest on voluntary savings and 6% annually on fixed deposits. The product structures, particularly for the loans are poorly conceived and probably result in net losses to the institution. Bugongi's accountant was capable but was not equipped with skills to do proper cost accounting.

Kyamuhunga:

Kyamuhunga had multiple products. These included: agricultural loans priced at 3%/month declining balance from 3 to 18 months, commercial loans priced at 3.5%/month declining balance from 6 to 9 months, school fee loans priced at 3.5%/month declining balance from 3 to 6 months, water tank loans priced at 3.5%/month for 12 months and solar energy loans priced at 3.5%/month for 12 months, overdraft facilities priced at 5%/month. Kyamuhunga offers fixed deposits paying 12% annually and ordinary savings paying 1% quarterly. Again, at this SACCO the products were not priced scientifically and certain products are very weak in terms of their contribution. However, the management does simple analysis to budget for products and tracks performance on a product by product basis.

Rubabo:

Rubabo has various loan products. These included: solar loans priced at 3%/month declining balance for 24 months, motorcycle loans priced at 3%/month declining balance for 6 months with a 50% down payment, fees for schools priced at 3%/month declining balance for three months, and fees for university priced at 3%/month declining balance for six months. Rubabo pays 4% annually on all deposits. Again, there was no differentiation on the basis of contribution and no analysis of cost of delivery.

Ikongo:

Ikongo charges 3%/month flat rate on all loans and has a maximum loan period of 6 months. Ikongo pays no interest on ordinary savings and pays 1.5% monthly on fixed deposits. This system is simple and perhaps appropriate because their internal capacity is extremely weak.

Training:

Based on field observations, a training program and manual were developed in consultation with USAID/Rural SPEED in Kampala. The training module specifically addressed constituent costs of product delivery, loan yield calculation, determination of maturity gap, contribution margin on a product by product basis and review of existing SACCO products.

The training took place in Mbarara from December 11 to 13, 2006. The training itself was moderately successful. Concepts were difficult and a language barrier, particularly on highly technical aspects, limited comprehension. Following the training, a quiz was administered and the average score was 80%. While these indicated good results, the consultant actually anticipated higher scores. One particular participant from Bugongi had a stellar performance and perhaps going forward should serve as a resource person to other SACCOs in the region. One SACCO, Muhame, did not participate in the training.

Mentoring:

One day mentoring sessions were conducted at each of USAID/Rural SPEED's partner SACCOs. The sessions built on the course materials and specifically addressed weaknesses identified during the first phase of the consultancy. As a blanket statement, this training and mentoring was encumbered by the fact that none of the SACCOs as yet have computerized MIS which is a precursor to effective cost accounting. Specifically, the consultant recommends the following for each SACCO:

MAMIDECOT:

This SACCO will soon be computerized with effective MIS software. Conceptually the management understands cost accounting but is lacking the technology to do it effectively. In the short term the SACCO should concentrate on making income predictions on a product the basis from the loan portfolio. After this fundamental step more complex cost accounting can be entertained.

Shuuku:

Shuuku participated poorly in the mentoring session and few board members actually materialized. Many questions were raised because the participants in mentoring were not present at the training. Therefore, the majority of the mentoring session was weak and based on revisiting training concepts.

Muhame:

Muhame did not participate in the training. However, in the mentoring session, it seemed that this SACCO has remarkably better accounting skills versus other institutions. The consultant recommends, as with others, that Muhame begin by developing income predictions on the basis of their existing products.

Kitagata:

Kitagata participated well in the mentoring. The institution committed itself to proper pricing of their loan products so as to determine the contribution margin of each. As with others, computerized MIS will be indispensable to pushing this SACCOs performance forward.

Bugongi:

Bugongi had the best overall participation in both the training and the mentoring. The SACCO can effectively execute the skills transferred in the training and mentoring. However, USAID/Rural SPEED should take careful note that the SACCO is wary that cost accounting may be in vain due to effective unfair competition that is anticipated by the government lending scheme (Bona Bagagawale).

Kyamuhunga:

Kyamuhunga has very effective accountants. Their performance is encumbered by a lack of quality computerized MIS. However, they are capable and confident that they can apply the skills acquired in training. As soon as possible they will classify their products on

contribution basis, select the most effective ones and drive out a plan for increased customer satisfaction. USAID/Rural SPEED should follow these efforts closely. The SACCO also expressed the desire that not management but also the board be trained in computerized MIS to better extract information from the systems. The consultant leaves the decision on this to USAID/Rural SPEED as they are more qualified to comment on the proper role of a SACCO board.

Rubabo:

Rubabo is planning to conduct a proper product pricing on the basis of USAID/Rural SPEED's training. At the mentoring session, the SACCO prioritized increasing outreach centers from 3 to 5. They were able to identify this intervention as a relatively low cost method to increase income. This was a training outcome. Further based on the costing their products, they have prioritized the recruitment of a reputable insurance firm to mitigate risk on cash (they had not costed this previously) and a reputable audit firm to ensure that their books accurately reflected the reality of their business.

Ikongo:

Ikongo participated weakly in the training and also weakly in the mentoring. This training was absolutely premature for this SACCO. The recommendation is for the institution to mobilize more savings and shares to counter their current narrow capital base. The SACCO also needs to address safeguarding their savings. This type of training can be revisited when the SACCO has a stronger fundamental foundation.

SECTION III

RECOMMENDATIONS

1. Broadly the consultant recommends that this training be reinforced on three levels. Proper product costing and pricing should be incorporated in the coming consultancy on savings product development. Secondly, it is a foundation for the upcoming consultancy in Treasury Management. Thirdly, USAID/Rural SPEED should actively follow up the individual SACCOs based on the needs revealed in the mentoring sessions.

2. Above all, there is a serious need to address the computerization of SACCO MIS. Without this fundamental capacity, proper costing and pricing will remain an intellectual, not a practical, exercise.

3. Specific to Ikongo, it is very necessary to build their fundamental balance sheet. Advanced topics in financial management are as yet too complex for this organization. Further, the organization could benefit greatly by engaging a qualified accountant as quickly as possible.

4. All SACCOs need to give their depositors more incentives to increase their savings balances when the were able to do so. Some of the SACCOs indicated that their members maintained savings balances only adequate to qualify them for the loans that they expected to need. But clearly some of their depositors did have excess funds available periodically. It was recommended that the SACCOs consider offering "tiered' savings accounts: the interest rate paid to the savers could vary depending on the average (or minimum) balance that the saver maintained over a given time period. The only "issue" that any of the SACCOs' Boards raised with this concept was that they needed enhanced calculating capabilities in order to implement such a policy. Hopefully, the computers and software that Rural SPEED is providing to the SACCOs will enable them to satisfy this need.

5. They need to have a better understanding of who their competitors were, and of how those competitors' products compared to theirs. Some of the SACCOs acknowledged that they had competition; others (including MAMIDECOT) said that they did not. They need to realize that there is always competition, even if it is only in the form of the alternative of not borrowing money at all.

6. The SACCOs need to expand and broaden their marketing efforts for both loans and deposits. It was suggested that, in addition to the "shotgun" marketing approaches they currently used, they should be identifying attractive potential customers in their markets, and marketing to these customers directly. Such customers are unlikely to react to radio advertisements or billboards: they need to be visited, and sold on a "one on one" basis. It also was suggested that Board members should try to identify one or two people in the community they knew who would be attractive customers, and then help the SACCO's managers attract those prospects to the SACCO. Another suggestion was made to approach the SACCOs' good customers, and ask them if they could recommend any friends or colleagues of theirs as potential customers to be approached.

Other attachments

At the end of the three day seminar, the attendees were given a short (ten true-false question) quiz, in order to gauge the level of their absorption of the materials covered. The quiz and the results are on the following pages.

USAID/RURAL SPEED Cost Accounting Seminar- December 11-13, 2006
Mbarara, Uganda

Course Quiz

Student Name:

SACCO Name:

1. True or False: The yield on a loan is equal to the interest rate on the loan, plus the Commitment Fee charged.

2. True or False: Cost accounting is a tool to help a SACCO's management to analyze its profitability

3. True or False: A properly managed SACCO should always charge the same interest rate for all of its loans.

4. True or False: The yield on a loan with a flat interest rate is the lower than it would be if the rate were charged on a declining balance rate.

5. True or False: Bankers call the difference between the interest rate they charge on loans and the interest rate they pay on savings the "Gap".

6. True or False: Retained Earnings is part of a SACCO's equity

7. True or False: Loan management costs do not change if the total loan portfolio increases or decreases

8. True or False: If a loan is written off, there is no reason for management to bother trying to collect on it.

9. True or False: It is never a good idea for a SACCO to borrow from a bank, as the interest rates are too high for the SACCO to make profits.

10. True or False: Managers of SACCOs need to be aware of what other lenders are doing regarding loans and savings accounts.

SACCO Seminar Quiz Results December 13, 2006

SACCO	Ñame **	Score
Rubabo	Teorisia Tusime	6
Rubabo	Esau Tunyahibwe	8
		SACCO AVERAGE: 7.0
Kitagata	Edger Mwesigwa	8
Kitagata	Moses Ihoooza	7
Kitagata	Harriet Kominoni	8
		SACCO AVERAGE: 7.67
MAMIDECOT	Godfrey Ssemuratya	8
MAMIDECOT	Andrew Benjamin Noawula	7
MAMIDECOT	Julius Kmemeera	7
		SACCO AVERAGE: 7.33
Ikongo	Samuel Muhindo	7
Ikongo	Abraham Kisembo Bitswamba	7
		SACCO AVERAGE 7.0
Kayonza	Benon Kusasira	8
Kayonza	Ivan Masaemenewa	7
		SACCO AVERAGE: 7.5
Bugongi	Edward Mugizi	9*
Bugongi	Godis Mukgize	6
Bugongi	Denis Ashibu	7
		SACCO AVERAGE: 7.33
Kyamuhunga	Ronald Mwebe	8
Kyamuhunga	Joseline Twimomugisha	6
		SACCO AVERAGE: 7.0
Shuuku	Deo Mubangizi	8
		SACCO "AVERAGE": 8

- * Note: Highest score achieved by Edward Mugizi of Bugongi SACCO

**Note: Last names are from my (JY) reading of the attendees' handwriting.