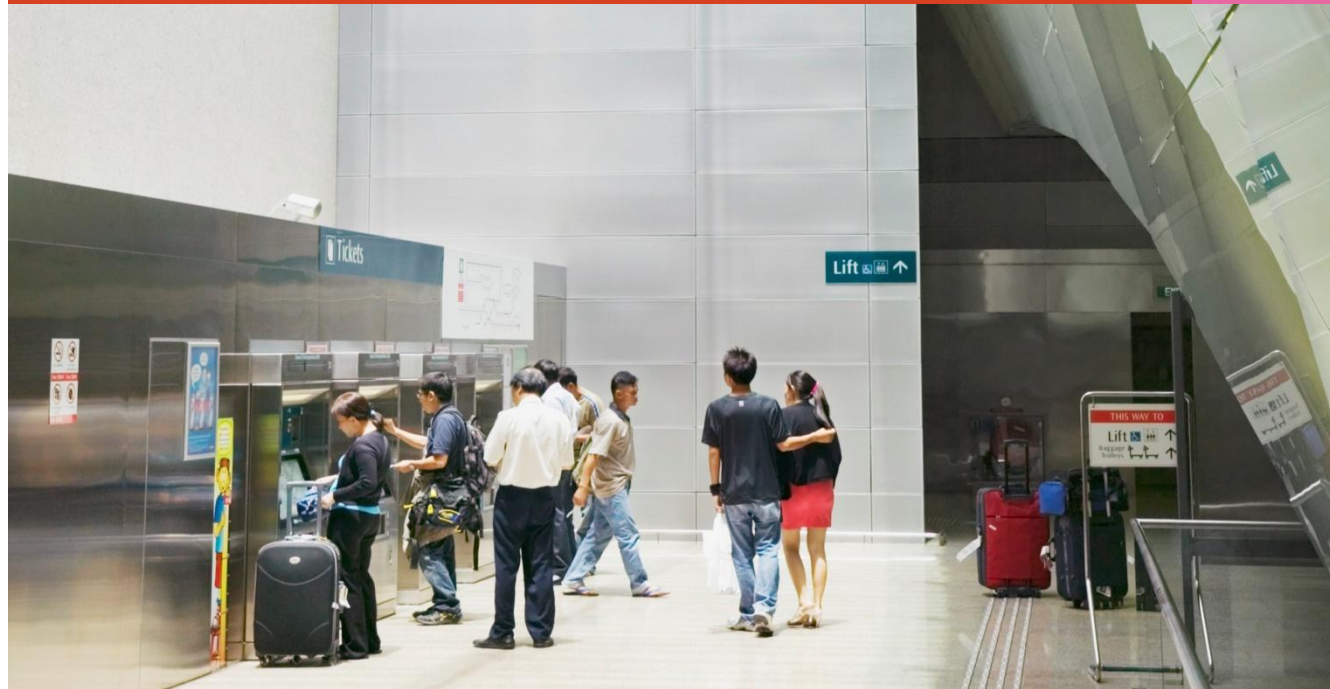


A publication of PwC's Financial Services Institute (FSI)

# *In the Cards:* Preserving Profitability in the Post-CARD Act World

October 2010



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# *Section 1*

Point of view

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## *Point of view*

The landscape for credit card issuers changed after the CARD Act of 2009 was implemented.

**The financial crisis of 2007-2009 and the CARD Act of 2009 had a profound impact on the credit card industry. The resulting changes in consumer habits pose a continued challenge to issuers.**

On May 22, 2009, President Obama signed into law the Credit Card Accountability, Responsibility, and Disclosure Act (the CARD Act of 2009). The purpose of the CARD Act was to establish fair and transparent practices relating to the extension of credit under open-ended consumer credit plans. The act introduced changes to common billing and other practices, which were to be fully implemented by February 2010. These changes are perhaps the most significant the industry has ever experienced and impacted all stakeholders in the industry. The act has resulted in tighter credit for many consumers and caused credit card issuers and their technology partners to incur significant expenditures to conform to its mandates.

In addition to the new legislation, between 2007-2009, the United States experienced its most significant recession since the Great Depression. The decline in credit card usage and consumer deleveraging that typically occurs during recessions was more pronounced in the recent downturn. We observed an initial industry contraction as carriers took measures to shed riskier, sub-prime accounts and reduce risk and loss. According to the July 2010 Senior Loan Officer Survey, indicators of changes in standards and terms for approving applications for credit card loans were mixed. Large banks reported a net easing of terms on credit card loans, while other banks reported a net tightening (since the previous survey in April 2010).<sup>1</sup> Revolving debt decreased 9.6% in 2009 and has decreased at an annualized rate of 6.3% as of July 2010.<sup>2</sup>

Following this volatile period, from September 2009, through July 2010, personal consumption expenditures increased 2.9%.<sup>3</sup> On September 20, 2010, the National Bureau of Economic Research announced that the recession that began in December 2007 had ended in June 2009.<sup>4</sup> A rebound in consumer spending has already resulted in accelerated profits and revenues for the largest electronic payment networks through the first quarter of 2010.<sup>5</sup> Despite this, we expect that consumers will continue to deleverage their personal balance sheets, which should have a direct impact on issuer profits and will keep the rate of consumer spending in the United States muted for a number of years.<sup>6</sup>

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<sup>1</sup> Mary Beth Chosak and Thomas Spiller, "FRB: Senior Loan Officer Opinion Survey: July 2010," The Federal Reserve Board (August 16, 2010) <http://www.federalreserve.gov/boarddocs/snloansurvey/201008/default.htm>, accessed September 21, 2010

<sup>2</sup> "FRB: G.19 Release—Consumer Credit—September 8, 2010," The Federal Reserve Board (September 8, 2010) <http://www.federalreserve.gov/releases/g19/Current/>, accessed September 21, 2010

<sup>3</sup> PwC Calculations. Personal consumption expenditures. Data source: Bureau of Economic Analysis/Haver Analytics

<sup>4</sup> "Business Cycle Dating Committee, National Bureau of Economic Research," National Bureau of Economic Research (September 20, 2010) <http://www.nber.org>, accessed September 21, 2010

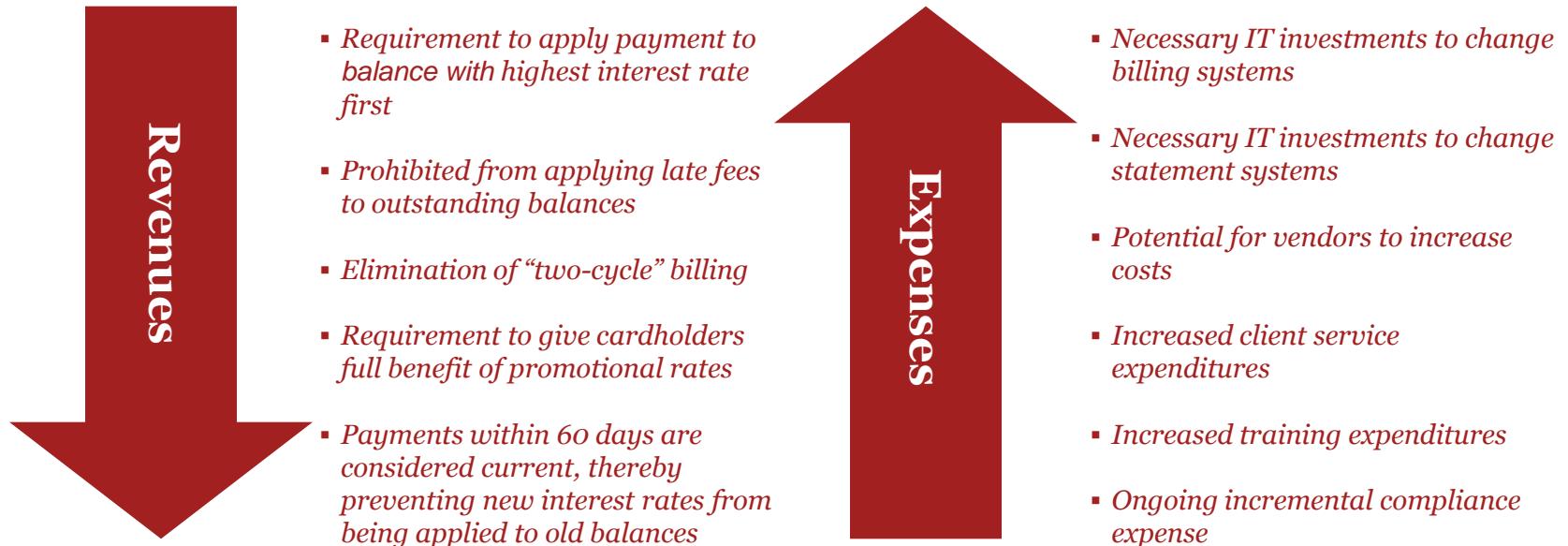
<sup>5</sup> "MasterCard Profit Climbs as Consumers Boost Spending," May 5, 2010. Euclid Infotech - Banks and Financial Institutions News.

<sup>6</sup> "The New Rule of 10%: The Coming Pension Crisis, Higher Savings Rates, and Fundamental Changes in the US Financial Services Industry," PwC, May 2010

## *Point of view*

The CARD Act has amplified existing pressures on issuer profitability, requiring issuers to fundamentally evaluate and adjust their business models.

**While the new legislation took direct aim at many revenue-producing practices, it has indirectly driven up expense for issuers and their technology partners as they modify technology platforms and operational processes in an effort to comply with the new laws.**



Effectively, issuers are facing pressure on two fronts. Issuers are aggressively changing the revenue side of the business model by introducing more fee-based revenue items, such as inactivity fees. However, for issuers to preserve profitability in a sustainable way, fundamental changes are required on the expense side. These changes involve new ways to monitor, measure, and assign expense versus the traditional mechanisms of allocations and approximation.

## *Point of view*

Issuers should assess the changes already made to their operating models to comply with the CARD Act, and determine whether these changes were effectively implemented.

**Following issuers' implementation of key changes made to comply with the CARD Act, two differentiators emerged between those issuers who effectively implemented these changes and those who experienced significant profit erosion: careful evaluation of business drivers and planning of key activities.**

A strong communication and monitoring environment also emerged as a hallmark of more successful issuers as this type of environment is critical to the speed with which issuers were able to implement strategic decisions and operational compliance.

Business drivers	Key activities
Brand equity and reputation	<ul style="list-style-type: none"><li>▪ Shed risky accounts and mitigate further losses</li><li>▪ Develop a plan to mitigate impacts on brand equity and reputation</li><li>▪ Establish and execute a robust loss mitigation program</li></ul>
Risk management, internal audit, and employee training	<ul style="list-style-type: none"><li>▪ Involve risk management in day-to-day operations to a greater degree</li><li>▪ Ensure that customer touch points become more vital in the short term</li><li>▪ Incorporate new requirements of the card business into internal audit's plans</li><li>▪ Institute effective employee training</li><li>▪ Invest heavily in the short term to realize cost savings in the long term</li><li>▪ Ensure that unused capital is actively managed to avoid inefficient use of capital</li></ul>
Service providers and communication plans	<ul style="list-style-type: none"><li>▪ Assess internal systems to determine compliance with changes in statement processing, mailing, and payment allocation requirements</li><li>▪ Develop effective internal and external communication plans to ensure timely and appropriate issue discovery and resolution</li><li>▪ Develop enterprise-wide strategies for communications across product lines</li></ul>
Operations, technology, and profitability	<ul style="list-style-type: none"><li>▪ Consider impacts on business model, operational functions, and relevant technology and applications</li><li>▪ Understand the cost drivers of the new operating environment</li><li>▪ Adjust pricing practices to become compliant</li></ul>

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## *Point of view*

Issuers initially largely focused on shedding riskier relationships in an effort to preserve profitability and shareholder return.

### **Issuers concentrated their efforts on shedding risky accounts to reduce exposure and mitigate further losses.**

Forecasting and subsequently pricing credit risk has been a challenge for issuers as they adjust to the new legislation. As such, the industry's contraction has largely been attributable to short-term defensive measures rather than to fundamental changes in the marketplace. As issuers continue to revisit and adjust their credit and underwriting policies and risk tolerances, the contraction should be short-lived and growth should return. This scenario is especially true for issuers that reside within a traditional banking infrastructure and may be better positioned to absorb losses.

### **Given these efforts, sub-prime and non-prime accounts are not expected to be the primary drivers of long-term growth, as they once were.**

Although non-prime accounts generally have higher default rates, in the past, issuers were able to re-price these accounts as borrowers' behavior changed. Regulatory changes now make it more difficult for issuers to re-price and change the terms of their cardholder agreements, thereby increasing the risk dynamics associated with this segment of cardholders. As a result, issuers are expected to increase their "pay to play" fees for all consumers, fueling the debate as to whether the changes actually benefited consumers as intended. Conversely, issuers may exit the segment altogether.

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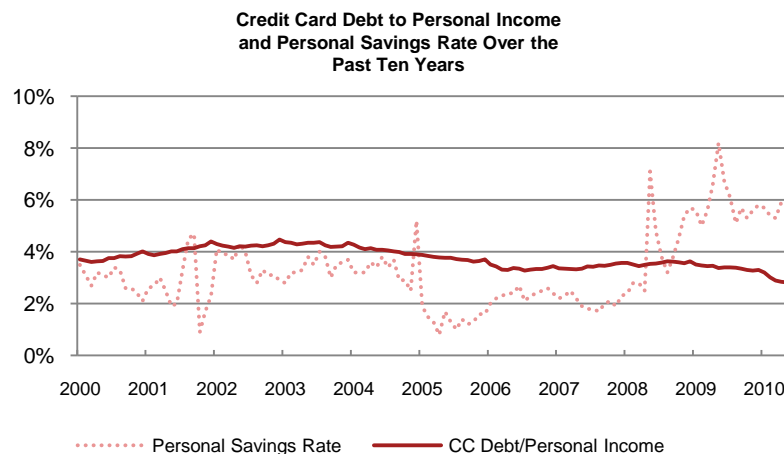
## Point of view

Issuers also took measures to sustain revenues more recently by introducing more fee-based pricing models—these measures have not gone unnoticed.

**Issuers are shifting to fee-based revenue models in an attempt to recover lost revenue. These measures, short-term in nature, are not going unnoticed.**

Issuers have taken actions to help offset a predicted reduction of \$11 billion per year in revenue from the industry's overall interest income as consumers continue to deleverage and increase savings. These actions have primarily been a steady increase of current fees and an introduction of new fees, for example, an inactivity fee that essentially penalizes cardholders who have not recently used their cards.<sup>1</sup> Overall, credit card companies imposed \$22.9 billion in penalty fees in 2009, up over 20% from 2008, and they are expected to continue to place more emphasis on fee-based items going forward.<sup>2</sup>

This behavior has not gone unnoticed, however. In August 2010, the Federal Reserve implemented new limits on credit card penalty fees that could cost the industry an additional \$3 billion in revenue per year.<sup>3</sup>



<sup>1</sup> Aparajita Saha-Bubna, "New Late-Fee Limits Could Cost Card Issuers \$3 Billion," Dow Jones Business News, August 20, 2010

<sup>2</sup> Robin Sidel, "Banks Roll Out New Check, Card Fees," The Wall Street Journal, January 02, 2010, Page B1

<sup>3</sup> Aparajita Saha-Bubna, "New Late-Fee Limits Could Cost Card Issuers \$3 Billion," Dow Jones Business News, August 20, 2010



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## *Point of view*

In determining longer-term actions to preserve profitability, issuers should consider focusing on examining cost drivers to succeed in the post-CARD Act environment.

**As scrutiny continues on revenue generation practices, increased attention and focus on sustainable cost reduction are expected to become vital to restoring profitability.**

It is imperative that issuers implement cost reduction strategically to increase profitability and remain viable in the “new” market. More importantly, issuers need to ensure that cost reduction efforts are sustainable to maximize their impact and long-term value contribution. If carefully evaluated and effectively implemented, these sustainable efforts may enable issuers to create competitive advantages within their operating models.

**The first step issuers should consider taking is assessing how dynamic (or not) their operating models are.**

As the industry has evolved, many issuers have not. Many issuers rely on legacy technology that has hindered their ability to be agile and reactive to change. We believe that many issuers have ignored the need to perform effective reviews of their cost drivers and to develop robust processes and procedures to enable change on a more “real-time” basis. This is, in large part, due to complacency over the last 30 years, while the credit card industry was experiencing strong growth. However, with margins now significantly diminished, issuers should quickly consider adjusting the fundamentals of their business in order to maintain a healthy business model.

Margins are expected to continue to be squeezed for a period of time. New regulations hinder the ability of issuers to recoup quickly the revenues they will lose as a result of the recent changes, with estimates of up to \$11 billion per year.<sup>1</sup> Since mid-2009, most issuers have focused on meeting new requirements, and necessarily deploying resources to that end. With implementation complete, issuers now need to prepare to face the new reality that their current operating cost structure cannot be sustained in the post-CARD Act world.

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<sup>1</sup> Aparajita Saha-Bubna, "New Late-Fee Limits Could Cost Card Issuers \$3 Billion," Dow Jones Business News, August 20, 2010

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## *Point of view*

Issuers that adopt new leading practices and better understand their cost drivers are expected to be better positioned to grow and be profitable in the post-CARD Act world.

**New leading practices in cost management provide an array of benefits and will help issuers transform their operating models to be more nimble and cost effective.**

Traditional cost systems do not have the capacity to accurately allocate costs to specific products. Traditional cost accounting assigns overhead costs by volume or by department, and both approaches create a distorted view of resource consumption. In response, companies that apply leading practices implement new costing methods to break down overhead costs by assigning costs to specific activities, rather than by volume or department.

New leading practices to capture costs by category use process mapping to distinguish activities that make up a process and to categorize disparate activities under individual cost pools. By assigning cost drivers to each pool, companies can more accurately track costs to individual products, customers, or services. Companies are also using these new costing methods to make predictions about and drive operating and strategic decisions.

### **Some examples of benefits realized include:**

- More accurate assignment of costs and tighter control of costs
  - Sharper identification of profitable customers
  - More accurate identification of value-generating products and services
  - Greater ability to predict future revenue flows
  - More accurate budgets
  - Better pricing models
  - More efficient processes
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## ***Section 2***

A framework for response

## A framework for response

Issuers that proactively assess and change their cost management practices are expected to benefit immensely.

**Being able to pinpoint and isolate fixed and variable costs will become vital survival and growth skills for issuers over the next three to five years.**

### Traditional Practices

Income Statement	
<b>Revenue</b>	
Net Interest Income	\$ xxx
Fees/Service Income	xxx
Other Services	xxx
<b>Expenses</b>	
Comp and Benefits	xxx
Information Tech	xxx
Prof & other Services	xxx
Occupancy	xxx
Other	xxx
<b>Net Income</b>	<b>XXX</b>

- Costs captured by category, then allocated back to business (versus product or customer)
- Additional measures are approximated using secondary allocation
- Fixed versus variable costs are not readily isolated

Traditionally, most expenses, such as compensation, marketing, and specific professional services, have been captured categorically and then allocated back to various business lines. Additionally, further expenses, such as enterprise level expenditures (IT, occupancy, etc.), may be attributed to business lines via secondary allocations and/or approximations.

This practice of allocation and approximation makes it difficult for issuers to pinpoint and isolate fixed from variable costs, which, in turn, makes it difficult to determine true profitability. Being able to pinpoint and isolate fixed and variable costs will become vital skills for issuers over the next three to five years.

At a high level, all costs are assigned to processes/activities. Significant emphasis is placed on evaluating each cost and determining whether it is a true fixed cost versus a variable cost.

By doing so, issuers are expected to be better armed to view various product lines, customer segments, etc. on a fully loaded basis and to more accurately determine true value contribution to the organization.

### New Leading Practices

- Costs are captured by category
- Fixed costs versus volume-driven costs and drivers are developed
- Human effort and support costs are assigned to processes
- Processes view is by assignment to profit units (typically, products)

		TOTAL
Net Interest Income		XX
less: Relationship Pricing		XX
Fees / Service Income		XX
less: Discounts		XX
Servicing Expense		
	1.0 Account Opening	XX
	2.0 Transacting	XX
	3.0 Customer Service	XX
	4.0 Statements	XX
	5.0 Control	XX
Direct Product Expense		XX
Risk Expense		XX
Relationship Management Expense		XX
Direct Sales Force		XX
Other Captive		XX
Third Party/White Label	XX	
<b>NET CONTRIBUTION</b>	<b>XX</b>	

## *A framework for response*

Card issuers should consider adopting new leading practice cost evaluation tactics to gain more relevant insights into their business and more effectively manage it.

**Effective expense management allows institutions to better calculate key drivers, providing for more streamlined analysis efforts to better inform and provide leadership with more relevant insights for more effective decision making.**

Once leading alternative cost measurement tactics are adopted and implemented, management can perform more detailed analysis on portfolio behaviors and dynamics. By doing so, management now has access to more relevant insights on the portfolios they manage and their business overall.

● **Analysis**

● **Insight**

● **Traditional calculation**

Processing center charges based on usage

Excess capacity

Direct product cost

Processing expense as percentage (%) of revenue

Cost per channel

Business case development

Staffing resource analysis

Customer profitability

Product profitability

Product performance by customer

Capacity utilization

**Strategic Insights:**

- Pricing validation for outsourcing, white labeling
- Pricing decisions
- Product entry/exit decisions
- Cross sell opportunities
- Economic impact of customer behaviors

**Operational Insights:**

- Process re-engineering opportunities
- Cost vs. benefits of automation
- Centralization/shared service opportunities
- Location – sourcing
- Performance management

Traditional cost evaluation tactics do not easily lend themselves to calculating the key cost drivers on which credit card businesses are measured today. To that end, many institutions are adopting alternative tactics to better calculate cost drivers that feed further analysis.

## A framework for response

Implementing these new tactics requires a disciplined approach to fundamentally changing the operating model while minimizing disruption to current operations.

Stage 1	Stage 2	Stage 3	Stage 4
Assess	Design	Build	Capture Value and Enterprise Deployment
Conduct a current-state process analysis, including identifying activities undertaken across middle and back office operations	Develop a future operating model	Identify areas of value in transition from old to new operating model	Implement new operating model, and capture identified opportunities
<ul style="list-style-type: none"> <li>Assess the existence and quality of current-state controls</li> <li>Evaluate current activities and drivers of these activities</li> <li>Model the activities and associated costs</li> <li>Assess organizational structures, roles, and governance</li> <li>Assess opportunities for consolidation/removal</li> <li>Review training and customer communications programs</li> </ul>	<ul style="list-style-type: none"> <li>Validate model calculations</li> <li>Assess adequacy of regulatory controls and communication programs</li> <li>Create a policy for performance metrics, reporting, escalation, etc.</li> <li>Design future state of operations</li> </ul>	<ul style="list-style-type: none"> <li>Identify areas of opportunities</li> <li>Develop value capture strategies</li> <li>Calculate ROI opportunity by strategy and prioritize</li> <li>Develop value capture execution strategy</li> <li>Implement workflow controls, exception identification, resolution, and reporting</li> </ul>	<ul style="list-style-type: none"> <li>Value capture:               <ol style="list-style-type: none"> <li>Business process reengineering</li> <li>Product pricing initiatives</li> <li>Capacity rationalization</li> <li>Benchmarking (internal and external)</li> </ol> </li> </ul>

### Benefits

- |  |  |   |   |
|--|--|---|---|
| <ul style="list-style-type: none"> <li>Documentation of operations and identification of root cause drivers</li> <li>Capture of costs by activity</li> <li>Mapping of regulatory controls</li> </ul> | <ul style="list-style-type: none"> <li>Development of empirical model</li> <li>Assessment of regulatory control adequacy</li> <li>Agreement on metrics in new operating model</li> </ul> | <ul style="list-style-type: none"> <li>Value opportunities identified</li> <li>ROI cases established</li> <li>Value capture execution plan defined</li> </ul> | <ul style="list-style-type: none"> <li>Value capture strategies initiated to reduce costs</li> <li>Proof-of-concept model transferred to client environment for sustainability</li> </ul> |
|--|--|---|---|

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## *Section 3*

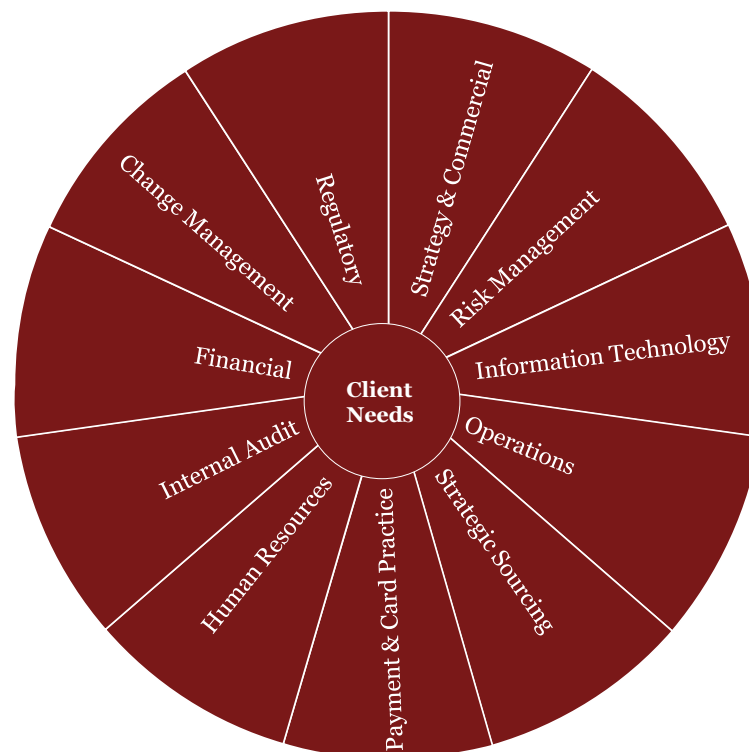
How PwC can help

## How PwC can help

### PwC's Financial Services practice

PwC's Financial Services practice has a specialized cross-functional group to assist our clients with the legislative, regulatory, operational, and market issues facing the credit card industry. The group has experience in compliance, sustainable revenue and cost management, loss mitigation, risk and controls, and banking operations and IT related to payments.

<b>Extensive experience</b>	We have designed and implemented new operating models for loss mitigation, call center training and improvements, and sustainable revenue improvement/cost containment operation analytics. In addition, we have extensive experience with the leading card and payment processing vendors in the industry.
<b>Industry focus</b>	Our seasoned team of specialists brings deep industry expertise and uncovers key issues, risks, and opportunities in the credit card and payments industry.
<b>Deep operations, finance, and IT experience</b>	Our team includes finance, human resources, regulatory, information technology, strategy, operations, and accounting advisory specialists.
<b>Tailored, integrated approach</b>	We tailor our approach and deliverables to your needs based on your strategic goals, your current operating model, and the details of the business case for change.
<b>A single point of contact</b>	Our dedicated Financial Services practice provides a single point of contact who can quickly mobilize the appropriate resources to assist you with your transaction needs.
<b>Global presence</b>	We have a financial services presence in over 25 countries, which can add significant value to companies addressing credit card issues globally.
<b>Solution-based approach</b>	Organizations have many choices with respect to addressing the risk, accounting, and operations issues related to the new legislative and regulatory changes for credit cards. We provide a tailored approach to address these issues in a sustainable fashion for your organization.





## *How PwC can help*

We provide solutions and support for operating model changes related to cards and payments.

Strategy	Transition
<ul style="list-style-type: none"><li>▪ Review of all required changes and operational implications</li><li>▪ Risk assessment and quantification</li><li>▪ Identification of operating model changes</li><li>▪ Development of implementation program to address operational model changes</li><li>▪ Cost/benefit analysis</li></ul>	<ul style="list-style-type: none"><li>▪ Transition project management</li><li>▪ Risk assessment</li><li>▪ Business process redesign</li><li>▪ IT applications alignment</li><li>▪ Communication protocols</li><li>▪ Change management</li><li>▪ Human resource management</li><li>▪ Compliance</li></ul>
Compliance and risk management	Business model impacts analysis
<ul style="list-style-type: none"><li>▪ Development of a compliance implementation plan addressing the timing and extent of policy, procedure, disclosure, system, and vendor changes</li><li>▪ Development and review of operational impacts, service levels, and key performance indicators</li><li>▪ Controls review and improvement</li></ul>	<ul style="list-style-type: none"><li>▪ Operational review and assessment of impacts</li><li>▪ Development of an actionable implementation plan to improve the business model</li><li>▪ Development of sustainable cost management capability</li><li>▪ Development and implementation of a robust loss mitigation program</li></ul>

## *How PwC can help*

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## *Section 4*

Select qualifications

## *Select qualifications*

### Technology costing in support of outsourcing—top credit card issuer

<b>Issues</b>	Client was looking to drive down fixed costs associated with technology support of the card business. Prior to moving to a variable cost structure associated with outsourcing, the client needed to clearly identify cost drivers and components.
<b>Approach</b>	We helped develop a new costing system for the technology division with a total spend of \$600 million. We used cost information as the baseline to support the analysis requirements for outsourcing both ADM and infrastructure.
<b>Benefits</b>	<ul style="list-style-type: none"><li>▪ Helped to develop a rapid baseline measurement of technology costs. (SAS)</li><li>▪ Helped build a management reporting capability around the new costing system. (Hyperion)</li><li>▪ The new reporting capability is utilized to effectively manage the outsourced operations and help achieve cost savings.</li><li>▪ Used costing information to help evaluate third-party bids for outsourcing the application development and maintenance activities, as well as the technology infrastructure activities.</li><li>▪ The client saved over \$100,000 per year from this data.</li></ul>

## *Select qualifications*

### Technology cost transparency and ADM cost takeout—large regional bank

<b>Issues</b>	This large regional bank wanted to drive improvements in its application development and maintenance functions via cost transparency.
<b>Approach</b>	There were five ADM groups (retail bank, commercial bank, home loans, credit card, and corporate), each with separate and distinct policies, processes and offshore/onshore strategies, etc. We helped develop technology cost transparency data to benchmark internally across these ADM groups.
<b>Benefits</b>	<ul style="list-style-type: none"><li>▪ Helped develop a rapid prototype cost baseline of the application development and maintenance functions of the major regional bank with total spend of \$700,000. (SAS)</li><li>▪ Helped to modify existing chargeback system to provide more robust, actionable cost information. (PeopleSoft)</li><li>▪ Based on the analysis, if an alternative business model was implemented to consolidate like functions into centers of excellence supporting the entire bank, it would likely yield \$50 million in savings.</li><li>▪ Client is implementing this change and expecting to achieve the projected savings target.</li></ul>

## *Select qualifications*

### Cost development and recovery system—major US bank

<b>Issues</b>	After the merger of two major US banks, we were engaged to assist in the development of a new system to measure the costs of services delivered to the bank by the new “services” company, which included technology and operations.
<b>Approach</b>	We helped the client to apply an activity-based approach to develop the costing information for services delivered to the bank.
<b>Benefits</b>	<ul style="list-style-type: none"><li>▪ Helped build a fully functioning service costing and chargeback system for technology and operations groups with an annual budget of more than \$5 billion. (SAS)</li><li>▪ Helped build a reporting capability to provide drilldown for chargeback invoice detail. (Oracle)</li><li>▪ Helped build a planning and budgeting process and online forecasting system to allow annual service pricing and support a “zero-based” budgeting process. (Oracle)</li><li>▪ Internally benchmarked performance across multiple items-processing centers, data centers, and operations centers.</li><li>▪ Helped identify and implement cost savings opportunities exceeding \$40 million. One example: The reject repair rate was found to be particularly bad in several items-processing centers. Through replacement of old equipment, the reject rate was improved by several percentage points which corresponded to an \$18 million savings annually.</li></ul>

## *Select qualifications*

### Cost transparency and reduction—top thrift institution

<b>Issues</b>	This top thrift had tried to build a new costing and chargeback capability for its technology department four times previously, but failed each time. We were engaged to successfully develop and help implement this capability.
<b>Approach</b>	We helped to develop a new costing and chargeback capability using an “ABC Lite” approach. In parallel, the project produced over \$38 million in cost takeout. The project was completely self-funded, with significant savings exceeding the cost of implementation. This initiative was successful because it was implemented in seven months and focused on sustainable cost takeout.
<b>Benefits</b>	<ul style="list-style-type: none"><li>▪ Helped build a fully functioning service costing and chargeback system for technology organization with an annual spend of \$1.6 billion. (SAS)</li><li>▪ Helped build a reporting capability to provide drilldown for chargeback invoice detail. (Business Objects)</li><li>▪ Helped build a planning and budgeting process and online forecasting system to allow annual service pricing and support a “zero-based” budgeting process. (PeopleSoft EPM)</li><li>▪ Helped define a new service catalog, which tied to the costing and chargeback system.</li></ul>

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