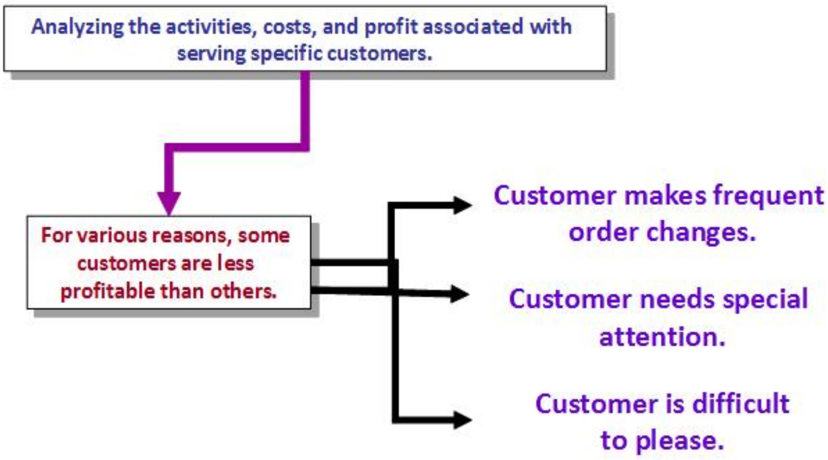
Chapter 5: Customer Profitability and Activity-based Management

This chapter focuses on an important application of ABC, which is to add more value at lower costs by improving the activities uses to make and deliver products.

ABM: Seeks to eliminate activities that customers do not value.

Customer value: Reflects the degree to which products and services satisfy customers' expectations about price, function and quality.

Customer profitability analysis: An application of ABM to processes that serve customers and sometimes is part of a larger management strategy called customer relations management where the qualitative and quantitative focus of the organisation is firmly fixed on the customer.



This chapter adds explicit focus on customer-level costs, which are costs incurred to serve specific customers.

LO 1: Understand the importance of customer profitability analysis.

Customer profitability analysis: Identifies the costs and benefits of serving specific customers or customer types to improve an organisation's overall profitability. Two primary objectives:

- Measure customer profitability.
- Status of being a supplier to a leading company, which can lead to referrals to other (more profitable) customers.
- Identify effective and ineffective customer-related activities.

The quantitative factors of customer profitability are important, but companies should not fail to consider qualitative reasons for retaining marginal or even unprofitable customers, including these:

- Potential for an unprofitable customer to become profitable by serving it more efficiently and by helping it succeed.
- Use of an unprofitable customer for entry into a new and profitable market by learning how to serve this market.
- Opportunity to receive transfers of knowledge from innovative but unprofitable companies about their cutting-edge needs or product applications.

- Ability to economise on customer-service activities for customers that partner with the organisation or share processes with it.

Similarly, a company might decline to serve some profitable customers whose business practices or goals are inconsistent with its own.

LO 2: Measure customer profitability using ABC

Administrative Cost Analysis

A large, unexamined category of cost at many firms is administrative costs. These often escape ABC analysis, because they are usually not associated with specific products. The steps to assigning these costs to customers emulate the ABC steps for products, but applied to customers.

1. Identify and classify the activities related to the company's customers.
2. Estimate the cost of activities identified in step 1.
3. Calculate a cost-driver base and rate for the activity.
4. Assign activity costs to customers using the appropriate cost-driver rates from step 3.

While this information would not be reported externally, if it is reasonably accurate, it can be valuable for making the types of customer decisions facing many companies.

Selling costs: include the costs of all personnel, databases, equipment and facilities devoted to supporting sales activities.

Marketing costs: Include the costs of personnel, databases, equipment and facilities dedicated to providing market research, marketing strategy and marketing plans.

Distribution costs: Include the costs of packing, shipping and delivering products or services to customers.

Finance and human resources costs: Costs of administrative functions that perform required internal and external reporting and analyses.

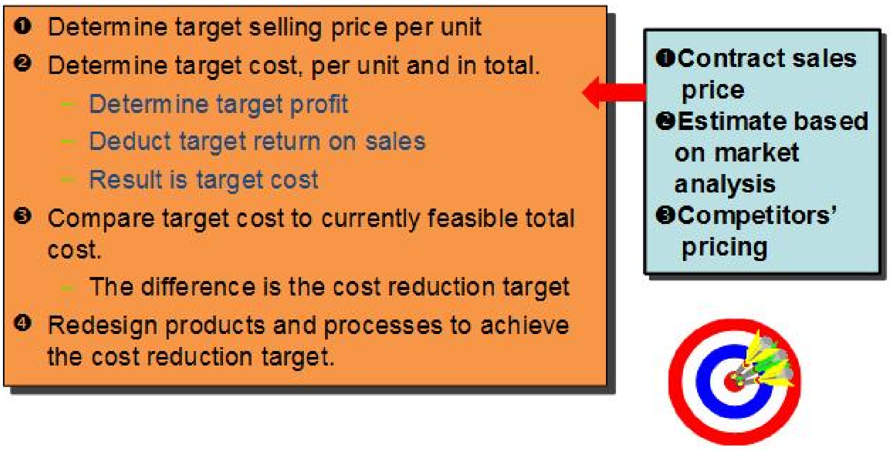
General administration costs: The other administrative costs that must be covered in some way by customer sales.

Four courses of action to improve customer profitability. The alternatives were:

- Continue the status quo; do nothing- this was not acceptable, but the status quo always needs to be visibly included.
- Increase the efficiency in serving the customer.
- Decrease administrative activity costs for all customers, without harming the profitable relationship.
- Drop the customer and the unprofitable product.

LO 3: Use activity-based costing with target costing.

Target cost: The highest cost of a good or service that meets both customer needs and company profit goals.



Customer margins must cover the firm's administrative and other opportunity costs that have not been assigned to each customer.

Currently feasible cost: The total cost without improving the efficiency of production or administrative processes.

Cost reduction target = Currently feasible cost – target cost

LO 4: Extend ABC costing to activity-based management.

This chapter continues to develop questions raised in Chapter 4 concerning how to build a cost management system that increases the understanding of the uses of resources and that promotes process improvements.

Activity-based costing focuses on:
1) Understanding the way resources are used in current processes.
2) Accurately measuring product costs using those processes.
However, ABC does not result in the process improvement that might be necessary to achieve desired efficiency.

Activity-based management: Evaluates the costs and values of process activities to identify opportunities for improved efficiency. ABM combines activity-based costing analysis and value-added analysis to make process improvements that improve customer value and reduce wasted resources. ABM extends basic ABC analysis.
ABM extends ABC by adding these steps:

> **Step 5:** Identify activities as value-added or non-value-added.
> **Step 6:** Score each activity as high or low value-added perceived by the customer.
> **Step 7:** Identify process opportunities to enhance value-added activities and to reduce or eliminate non-value-added activities.

Step 5

LO 5: Identify and measure the costs of activities that add value or do not add value in organisations.

The main objective of performing customer profitability analysis is to quantify the effects of continuing profitable or unprofitable customer-related activities.

Value-added activities: Enhance the value of products and services in the eyes of the customer while meeting the company's goals. In other words, the outcomes of value-added activities are what customers are willing to pay for.

Non-value-added activities: Do not contribute to customer-perceived value. Eliminating these activities by redesigning processes would not reduce customer value.

These are the most likely sources of the non-value-added activities:

- Building excess products to build up inventory (or stock).
- Waiting for processing.
- Spending time and effort to move products from place to place.
- Transporting workers to work sites.
- Building defective products.

The test for whether an activity adds customer value is met by answering two questions:

1. Would an external customer encourage the organisation to do more of that activity?
2. Would the organisation be more likely to reach its goal by performing that activity?

Step 6

Ideally, someone who is objective and knowledgeable about what customers value and what the organisation must do to meet its goals should measure value. It is unlikely, however, that one person could measure value reliably and without bias. The reasons are numerous:

- Everyone's knowledge is limited. Another possibility is that customers could have different values, and the organisation would have to decide whether to satisfy only one or many types of customer. This reinforces the benefit of using cross-functional teams.
- Everyone's responses are potentially biased.

In practice, analysts or market researchers measure value-added activities using anything from a single person's beliefs to sophisticated surveys of internal and external customers.

Step 7

LO 6: Use ABM to identify opportunities for process improvements.

The next ABM stage is to redesign processes to eliminate wasteful spending on non-value-added activities.

Risks: Exposures to loss, of eliminating activities that at first sight seem non-value-added.

Note that individuals in the organisation might derive benefits from the non-value-added activities, such as extra on-the-job perquisites, that indirectly add customer value (e.g., through better customer service attitudes).

The main intent of activity-based management: Use ABC information to improve processes by reducing cost while increasing customer value.

Bar-coding system: Creates unique bar codes for each batch and order and allows the company to mark and track all batches and orders electronically.

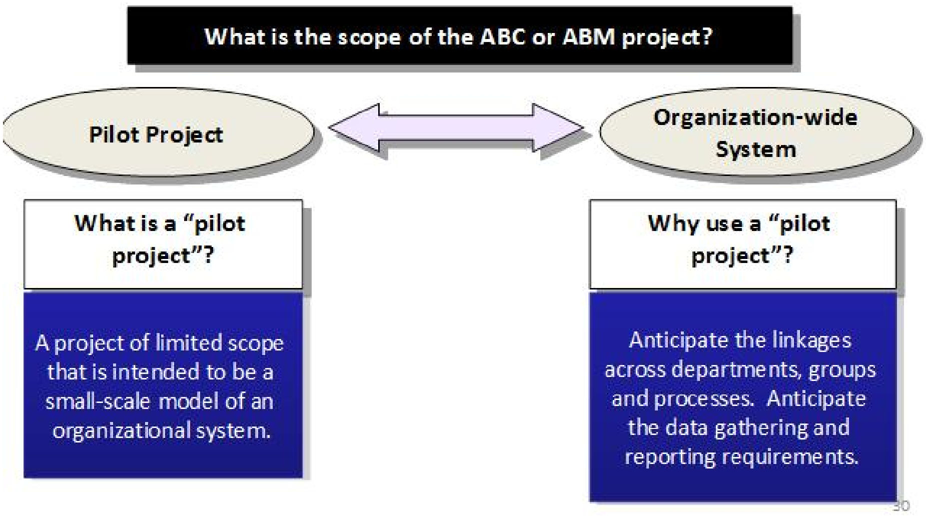
LO 7: Understand how to implement ABC and ABM.

Remember that ABC improves the accuracy of product costs given curren processes. ABM, however, identifies opportunities for improving processes, which should result in more customer value at lower cost.

Major planning issues:

- Scope of the ABC/ABM project
- Resources to plan and implement the project
- Resistance to change
- Information to be gathered
- Analysis team's responsibility for information analysis and decision making.

Scope of the ABC/ABM project
A small pilot project, which has a high chance of success, is a prudent way to introduce ABC or ABM to an organisation. A pilot project is a limited-scope project intended to be a small-scale model of a larger, possibly system-wide project.



Resources necessary

- Management commitment
- Personnel and time
- Technology resources

Resistance to change
Progressive organisations prevent or minimize resistance to change by:
1) Education and training
2) Widespread sponsorship and participation
3) Incentives to encourage and reward change

One **bottom-up approach** is to educate employees about the competitive necessity of ABC/ABM, give them a voice and influence in the analysis, and assure them that they will have meaningful jobs in the redesigned organisation. The alternative is to implement a **top-down approach**, using a team or a consultant to devise the solution and impose it on the organisation. One should expect more resistance to change in this approach, but a shorter development phase.

Effects of culture
A bottom-up approach might not work at all in a culture where employees regard criticizing existing processes as disloyal to their managers and the company.

Information to be gathered
ABC and ABM require information that is not normally available from an organisation's accounting system. Observations, interviews or surveys of the organisation's employees provide the needed information.

Analysis team's responsibility for information analysis and decision making
First, the team is intimately familiar with the data, their strengths and their weaknesses. Second, empowering and requiring the team to make recommendations gives them control and accountability for the entire project and motivates them to gather and analyse the data carefully and consider a wide range of opportunities for change.