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# **The Importance of Activity-Based Costing in a Performance Management Strategy**

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- ▶ *An Eye Towards Profitability Management in Your Organization*

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Audience: CFOs, finance professionals, pricing and costing analysts

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## Executive Summary

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Understanding customer and product profitability can mean the difference between promoting products and services that generate the greatest returns and wasting time and energy on a losing proposition. Consequently, as companies look to leverage their investment in enterprise performance management (EPM), improved profitability analysis is a necessary component to complete the picture of an organization's performance. With the improved insight EPM gives into strategic direction and the key performance indicators of every business unit, management's expectations for detailed insights are increasing—and the search for the "Holy Grail" of profitability analysis is intensifying.

Most executives recognize that, to have a complete picture of the performance of their business, they must conduct reliable cost and profitability analysis—they must have an activity-driven view into how their organizations' products, customers, and channels consume resources and incur costs. Without this foundation, profitability analysis will generate arbitrary or inaccurate representations of costs—and lead management to adopt ill-advised strategies.

This paper will underscore the importance of profitability analysis in providing a complete view of EPM, outline the risks associated with using simplified profitability measures, and illustrate how activity-based costing (ABC) contributes to more reliable and actionable customer, product, and channel profitability analysis.

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## The ABCs of Calculating Cost

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### Simple Cost Allocations Can Lead to Poor Decision-Making

EPM is allowing many companies to provide a process for evaluating and communicating strategy and giving each manager detailed reports and dashboards to help them make the right decisions for their business. However, in many cases, indirect costs are either ignored, or arbitrary measures—such as square footage or headcount—are used to determine how resources are being consumed by key customers, channels, or products. Poor assumptions in EPM information can lead to poor decision-making.

Prior to the emergence of ABC, companies typically calculated profitability using the allocation method. This allocation method involves allocating costs to a product or customer using metrics such as the total number of accounts, customers, products produced, or transactions. Table 1 gives a hypothetical example of how this method calculates the profitability of three customer channels: store, catalog, and internet. In this example, the company allocates overhead costs—including accounting, IT, marketing, and call-center costs—to customer channels, based on the number of customers per channel.

Table 1. Simple Allocation of Call-Center Overhead

	Total	Store	Catalog	Internet
Revenue	\$3,500,000	\$2,000,000	\$1,000,000	\$500,000
Number of Customers	50,000	35,000	10,000	5,000
Cost per Customer	\$10	\$10	\$10	\$10
Call-Center Costs	\$500,000	\$350,000	\$100,000	\$50,000
Net Revenue	\$3,000,000	\$1,650,000	\$900,000	\$450,000
Margin	85.7%	82.5%	90.0%	90.0%

This method of apportioning costs is not necessarily wrong. For instance, if customer behavior and hence the cost-to-serve are identical in each segment, then this allocation approach is adequate. However, in practice, customers in each segment are likely to exhibit unique behaviors that consume resources and cost in varying amounts—quickly rendering this simplified approach insufficient.

From the example above, management might conclude that all channels are performing relatively well, but the big opportunity lies in growing the catalog and internet channels through additional investments. These two channels—though smaller in overall revenue—appear more attractive after cost allocations and could realize explosive, profitable growth—given management attention and aggressive investments.

Table 2 shows the more realistic outcome when an organization applies ABC and apportions call-center expenses to each customer channel, based on the number of incoming calls each channel generates. Since catalog customers create 80% of the incoming call-center volume, this channel should incur a greater proportion of the total cost.

Table 2. ABC Allocation of Call-Center Overhead

	Total	Store	Catalog	Internet
Revenue	\$3,500,000	\$2,000,000	\$1,000,000	\$500,000
Number of Calls	100,000	0	80,000	20,000
Cost per Call	\$5	\$5	\$5	\$5
Call-Center Costs	\$500,000	\$0	\$400,000	\$100,000
Net Revenue	\$3,000,000	\$2,000,000	\$600,000	\$400,000
Margin	85.7%	100%	60.0%	80.0%

The insight from this analysis is far different. After allocating costs based on the consumption of resources, management can see that the catalog channel uses far more resources and is actually less profitable than other channels. Rather than throwing away additional investment to grow this channel, management should take corrective action to bring this segment up to acceptable profitability levels.

### **ABC: The Foundation for Cost and Profitability Analysis**

To gain a more complete understanding of customer, product, and channel profitability, companies are increasingly using ABC to correctly calculate costs. Because costs vary by product, delivery channel, and geography, ABC enables companies to define activities at the macro level—sale of a product—or at a more detailed level—an individual call to a call center. One of the key challenges for large organizations is to understand how each segment of the business consumes company resources. The best way to quantify this is to apply a structured, ABC methodology to calculate how products, customers, and channels consume activities and how these activities in turn consume resources. Figure 1 shows the basic flow of costs in an ABC model. In practice, the flow is more complex and often includes reassignments and reallocations of costs.

# Meeting the Challenges of Profit Analysis

## The Right Level of Analysis

EPM enables companies to look at their business from a number of different perspectives and scenarios. There are inherent risks associated with taking too narrow a view of the business, and only looking at profitability along a limited number of dimensions. If a company only reports profitability at the highest level, such as by customer segment, this may mask the fact that there will be unprofitable customers even in the most profitable segments. And by focusing exclusively on product or channel profitability, a company may eliminate products and channels that are actually used by highly profitable customers. It's important to measure and analyze profitability across all three dimensions—product, customer, and channel—and at the right level of detail, before taking any actions to rationalize the product portfolio or channel network.

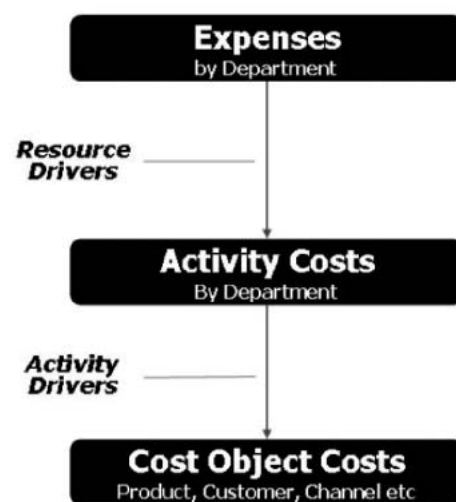


Figure 1. The Basic Flow of Activity-Based Costing

Although customer profitability is one of the key deliverables of most ABC initiatives, many other EPM initiatives will also benefit from detailed transactional analyses—such as costing each sales transaction to understand cost of sales—and companies should consider these benefits. The consistent and trusted information that results from an EPM implementation can enable organizations to leverage their investment to begin the process of calculating detailed profitability figures.

Many data warehouses already contain detailed transaction histories at the customer level, frequently enriched with syndicated customer data. By using this data to calculate costs at a transactional level, organizations gain complete flexibility to conduct analysis and reporting at any higher level. For instance, if all the individual transactions of each account have costs assigned, management can analyze profitability by the size of transaction, time of day, channel, or any other parameter captured in the data warehouse.

# Conclusion

EPM enables companies to align their people, processes, and technologies around common plans to optimize business strategy. By providing an integrated framework that includes profitability analysis and ABC, accurate and representative cost allocations form the basis for reliable decision-making. Companies that want to improve the insight from their EPM investment and include profitability analysis should:

- ▶ Avoid oversimplified cost allocations that misrepresent consumption of resources
- ▶ Build a reliable profitability measurement based on the ABC methodology
- ▶ Define the degree of profitability detail required to ensure adequate insight for decision-making
- ▶ Ensure the ABC methodology supports a multistep, multidimensional allocation of activity costs to projects

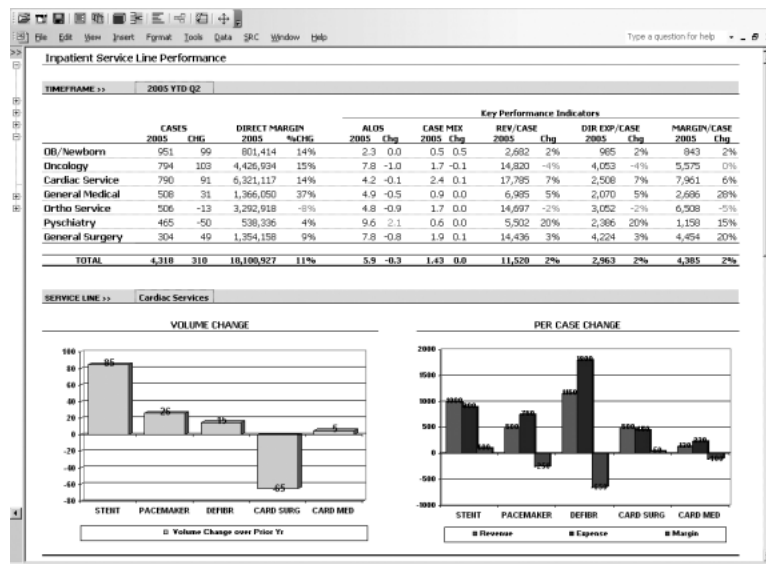


Figure 2. With EPM tools from Business Objects, highly interactive management reports turn data into actionable information.

For more information on EPM and profitability analysis solutions from Business Objects, visit [www.businessobjects.com/solutions](http://www.businessobjects.com/solutions) or call + 1 866 681 3435.







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