

Activity Based Costing Case Study

Profit-Chain Consulting

Our Client

Wholesale distributor of health equipment and supplies serving about a third of the continental US. This 20 year old, privately held company had multiple distribution centers each serving a geographic territory. The Company's wide breadth of product offerings includes surgical supplies, pharmaceuticals, supplies, and diagnostics.

Like many companies its size, the client sought to break through the \$100 million "glass ceiling," and make the critical transition to a large company. They were considering new business strategies to: expand into additional geographies, offer national buying groups discounts, and target large, growing national accounts.

Gross Margin vs. Profit

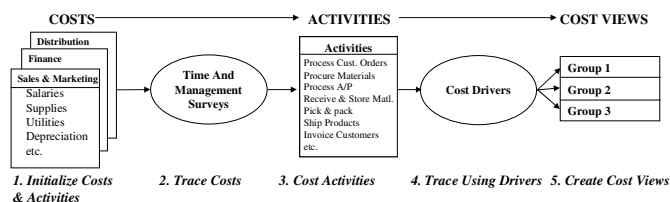
Customer profitability was a key driver for resource allocation and investments. They sought to both grow and increase returns and had some concerns with the margins on some accounts and customer segments. Did it really make sense to go after more business from some accounts when margins were lower than their core business? Some executives argued that the freight and other below the margin line costs compensated for the differences in margin.

	Customer Segments			
	Group 1	Group 2	Group 3	Total
Revenue	\$86,252,839	\$5,248,692	\$8,256,788	\$99,758,319
COGS	(70,343,225)	(4,729,409)	(7,766,001)	(82,838,635)
Gross Margin	15,909,615	519,283	490,787	16,919,684
Variable Costs				(3,154,309)
Contribution Margin				13,765,376
Fixed Costs				(10,135,326)
Profit (Loss)				3,630,049

Customer group 1 generates the vast majority of sales and margin. It has the highest margin percent of sales, but the profit by group still seemed elusive as various perspectives existed on how to "spread" variable and fixed costs. Profitability by customer group was very important to resource and investment decisions for growth.

Taking An Activity View

The two lower margin customer groups had the most opportunity for near term growth. Were Groups 2 & 3 profitable on a variable and fixed cost basis? This could only be answered by looking at what activities were different across the three groups and how those activities drive variable and fixed costs, which is the essence of an Activity Based Costing (ABC) project:



Starting from the general ledger and departmental budgets, the team mapped to activities and ultimately the three customer groups. The activities defined the business processes performed within the

organization, such as: process customer order, pick & ship and process returns. The volumes of these activities were identified to allocate costs to each segment. For example, once the cost of entering an order is determined, the number of orders was used to allocate costs to each group. Once all costs were segregated into fixed and variable and allocated to each group, profitability was determined:

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Gross Margin	15,909,615	519,283	490,787	16,919,684
Variable Costs	(2,972,979)	(137,102)	(44,228)	(3,154,309)
Contribution Margin	12,936,636	382,180	446,559	13,765,376
CM %	15.0%	7.3%	5.4%	13.8%
Fixed Costs	(9,214,516)	(403,644)	(517,166)	(10,135,326)
Profit (Loss)	3,722,119	(21,464)	(70,606)	3,630,049
Profit % of Sales	4.3%	-0.4%	-0.9%	3.6%

Using the ABC approach left little room for debate or doubt about profitability by customer group (or in a later study by product). This focused attention on the activities and how they were managed. The investment and resource allocations could be made with confidence.

Key ABC Findings

During the course of conducting the ABC study, many operational issues were discovered and resolved from the analysis:

- The breakeven for customer orders was determined and compared to individual accounts and customer groups
- Pick, pack and ship activities were determined to be almost four times as costly as warehousing.
- Electronic order processing (EDI) passed the breakeven point.
- Increased buying power from suppliers was a key element of leverage for growth in profitability.

Results

Over a five year period, the company successfully entered new geographic markets and dramatically grew with target customers:

- Sales increased 300% in a low growth industry
- Profits increased 270%

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