PERFORMANCE INCENTIVES IN ACTIVITY-BASED MANAGEMENT

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- Case study –

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ABSTRACT

The instructional case at hand addresses problems of managing customer profitability at a catalogue-based retailer. The case study discusses how lacking customer profitability can be gradually improved through several measures. These extend also to the transfer pricing system in the company. Students are asked to rewrite the bonus contracts of key personnel to implement the changes. The questions are open-ended and thereby allow for ample and detailed discussion in class.

Keywords: *Activity-based Management; customer accounting; target setting; teaching notes; transfer pricing.*

1. INTRODUCTION

CLASSY Ltd. is a catalogue-based seller of interior design items. Several times a year, the company sends fancy catalogues to their mostly mature customers. Customers can order from CLASSY over the phone (toll-free phone number), or by using the attached paper forms that go into the mail. CLASSY performs well in building lasting relationships with its customers, and repurchase rates are very high in comparison to industry average. The company generally gets consent to keep records of their customers (such as the names and birthdays of their pets, best friends, or their grandchildren). Sales personnel extends and utilizes this information during order calls, or two add personalized messages to those ordering by mail. Customers mostly pay by credit and debit cards. 70% of CLASSY's revenues are Cost of goods sold (COGS). Shipping and returns are free for customers. This includes overnight delivers, for which CLASSY incurs extra costs.

2. CUSTOMER ACCOUNTING (APPROX. 40 MINUTES)

CLASSY suspects that its costs for selling, distribution and administration (SDA) are not allocated to their customer groups in a way that cost allocation reflects the economic reality of the customer relationship. Currently, CLASSY allocates SDA cost based on gross sales. One of the management accountants ventures the idea to re-assess cost allocation using activity-based costing (ABC). The following information on customer groups is already available:

	Customer Type 1	**Customer Type 2**	**Customer Type 3**
Gross revenue [EUR]	440	4,000	12,000
Cost of goods sold [%]	*70%*	70%	70%
Returned items [#]	-	3	23
Returned items [EUR]	-	500	3,000
Mail orders – annual [#]	1	2	10
Phone orders – annual [#]	1	-	14
Phone time to place orders [h]	0.25	-	16.00
Deliveries – overnight [#]	-	-	14
Deliveries – regular [#]	2	2	10