Activity-Based Costing on a brand level - a must for a distribution company with several brands

The number of services, products and brands available for customers has increased rapidly over the past years. Globalisation has given the customer the opportunity to pick and choose from all corners of the world. As an example, one vehicle manufacturer that had 30 models in 1990, now offers over 300 models. (McKinsey). Companies are now forced to have a more customised and sophisticated offering, which results in an increased portfolio complexity. In this increased complexity, it often gets more complicated to know the true cost for each unit, with all overhead costs included. Thus, it has become more complicated to know the true profitability, in a time when it is ever so necessary.

AusCosmetic Group is an Australian based distribution company, with 140 employees, operating within the cosmetic and personal care sector. They have experienced rapid growth since its start in 2000, and have broadened its service from being a pure distribution company, to now also developing and maintaining their own brands. Their brand portfolio consists of their own 6 brands, making up 40% of the gross revenue, where the distribution brands make up the remaining 60%.

The value chain for AusCosmetic's own brands are described in figure 1 below. All brands and products are kept at the same warehouse and most of the office employees work with all brands as well, with services such as supply chain management, design, finance, marketing and sales. Therefore, the overhead costs and resources are being used by all brands. This has led to little knowledge on how the overhead costs and resources are being spent, and how the individual brands perform in terms of profitability.

In order to evaluate the brands' individual profitability, AusCosmetics had to develop a model on how to allocate their overhead costs, which constituted of three main cost groups; rent for the office and warehouse, financial costs and employee costs. The overhead costs make up almost half of the total gross revenue, which would evidently make a huge impact on the final brand profitability. In order to justly allocate the cost, the allocation model would require a more sophisticated accounting method than the traditional accounting methods. Therefore, Activity-Based Costing was used. Activity-Based Costing is a costing method arisen in 1980’s as a response to changed cost structures. Activity-Based Costing is based on the idea that it is the activities performed on the products that cost money, not the products themselves.

Figure 1. Presentation of the value chain for AusCosmetic Group’s products, stating what is performed by AusCosmetic Group and what is being outsourced.
Therefore, Activity-Based Costing allocates a business' overhead costs based on what activities the products require, combined with a calculated cost for these activities. The ABC methodology has been proposed for costing of products, customers, plants and brands, among others. However, most research has been made on the use of ABC on a product level and not brand level, making AusCosmetic Group’s situation an interesting case study.

The research started with a literature review, which was then followed by the case study. The aim of the case study was thus to identify what activities each brand required, and the frequency for them. Later, the cost of each activity was computed. In order to identify the activities and how often they were performed, qualitative data was obtained from formal and informal interviews, time trials and observations. This was then combined with a computed cost per activity, which was based on quantitative data found in AusCosmetic Group’s internal data systems. When using Activity-Based Costing, there is no right or wrong answer. For instance, approximately 40% of the warehouse personnel were picking orders, and it is therefore reasonable to assume that 40% of the warehouse personnel costs should be allocated according to number of orders picked per brand. But it is, however, a bit more complicated than so. The time for picking an order depends not only on number of products in the order, but also on number of different product lines and what brand it was. Some brands were more complex than others to pick, which consequently took longer. Therefore, many time trials were performed for picking an order for each brand. But even with the result from time trials, you can only get as close to the answer as an estimate. Therefore, many assumptions and simplifications had to be made. In order to verify the study’s findings, these were always discussed with the respective manager as well as the CFO. In addition, the qualitative and quantitative data was used to achieve triangulation. The complete research process is described in figure 2 below.

![Figure 2. Presentation of the case study's process.](image-url)
Conclusion
The findings of the research were two-folded; firstly, the case study gave clear indications on the brands individual profitability as well as shedding light on what activities that were driving the resources, and thus also the costs. Secondly, these company-specific findings gave valuable knowledge on the importance of using a sophisticated accounting method, such as Activity-Based Costing, and the usefulness of using it on a brand level. More specifically, the Activity-Based Costing’s result showed that four out of the six brands were unfortunately unprofitable, some of which had probably been for a long time. This had been hidden by some very profitable distribution brands. When the result of the ABC became evident, the research then focused on analysing the costs and the reasons for the brands unprofitability.

It became clear that AusCosmetics had launched new brands in order to achieve growth, which is much more costly than restructuring old ones. Furthermore, due to separate marketing initiatives, supply- and sales channels, AusCosmetic Group did not profit from the economy of scale, as much as was hoped. For instance, the sales costs yielded up to 50% of the revenue for some brands. This suggested that AusCosmetic Group should revisit its sales model, and streamline it to become less labour intense. Thus, the Activity-Based Costing did not only show the unprofitability of the brands, but also gave indications on why this was. Therefore, the Activity-Based Costing method is recommended to be used on a both strategic level, when deciding on what brands to further pursue, as well as on an operational level, when finding efficiency improvements. In a world with increasingly higher customer demands, in an industry with broad and complex brand portfolios such as the distribution industry, the use of Activity-Based Costing becomes a must.

References:
