REAL WORLD VIEWS 10.3

Cost-plus pricing at City Steel in Thailand

In the first quarter of the year 2015/2016, City Steel's total revenues (THB 135.44 million) decreased by 35 per cent compared with the previous year. Adverse economic conditions caused the Group's products to decrease substantially and made price competition become more intense. A drop in steel price of more than 30 per cent from the previous year had contributed to a decrease in the Group's total revenues. Since the Group employed cost-plus pricing strategy to determine products selling prices, once material costs decreased, the Group's sales revenues would decline, which caused the Group's net profits to decrease correspondingly. The Group had to reduce some mark-ups on the selling price in order to maintain sales revenues and retain customers. Also, the Group incurred some fixed expenses that did not vary according to a decrease in revenues.

Questions

1 To what extent did cost-plus pricing contribute to the decline in total sales revenues?
2 How might City Steel determine the price at which it sells steel?

References

Anonymous (2015) Thailand: CITY – Management Discussion and Analysis Quarter 1 Ending 31 Oct 2015. *Asia News Monitor* 16 Dec. search.proquest.com.libaccess.hud.ac.uk/docview/1749007079?pq-origsite=summon

CUSTOMER PROFITABILITY ANALYSIS

In the past, management accounting reports have tended to concentrate on analysing profits by products. Increasing attention is now being given to analysing profits by customers using an activity-based costing approach. **Customer profitability analysis** provides important information that can be used to determine which classes of customers should be emphasized or de-emphasized and the price to charge for customer services. Let us now look at an illustration of customer profitability analysis. Consider the information presented in Example 10.2. Note that the cost driver rate referred to in Example 10.2 represents the costing rates that have been computed by the company for the different activities. An explanation of how these rates are derived was provided in chapter 3. The profitability analysis in respect of the four customers is as follows:

	A	*B*	*Y*	*Z*
Customer attributable costs:				
Sales order processing	60 000	30 000	15 000	9 000
Sales visits	4 000	2 000	1 000	1 000
Normal deliveries	30 000	10 000	2 500	1 250
Special (urgent) deliveries	10 000	2 500	0	0
Credit collection[a]	24 658	8 220	1 370	5 480
	128 658	52 720	19 870	16 730
Operating profit contribution	90 000	120 000	70 000	200 000
Contribution to higher level sustaining expenses	(38 658)	67 280	50 130	183 270

Note
[a](Annual sales revenue × 10%) × (Average collection period/365)

You can see from the above analysis that A and B are high cost to serve whereas Y and Z are low cost to serve customers. Customer A provides a positive operating profit contribution but is unprofitable when customer attributable costs are taken into account. This is because customer A requires more sales orders, sales visits, and normal and urgent deliveries than the other customers. In addition, the customer is slow to pay and has higher delivery costs than the other customers. Customer profitability analysis identifies

EXAMPLE 10.2

The Darwin Company has recently adopted customer profitability analysis. It has undertaken a customer profitability review for the past 12 months. Details of the activities and the cost driver rates relating to those expenses that can be attributed to customers are as follows:

Activity	*Cost driver rate*
Sales order processing	£300 per sales order
Sales visits	£200 per sales visit
Normal delivery costs	£1 per delivery kilometre travelled
Special (urgent) deliveries	£500 per special delivery
Credit collection costs	10% per annum on average payment time

Details relating to four of the firm's customers are as follows:

Customer	*A*	*B*	*Y*	*Z*
Number of sales orders	200	100	50	30
Number of sales visits	20	10	5	5
Kilometres per delivery	300	200	100	50
Number of deliveries	100	50	25	25
Total delivery kilometres	30 000	10 000	2 500	1 250
Special (urgent deliveries)	20	5	0	0
Average collection period (days)	90	30	10	10
Annual sales	£1 million	£1 million	£0.5 million	£ 2 million
Annual operating profit contribution[a]	£90 000	£120 000	£70 000	£200 000

Note
[a]Consists of sales revenues less variable cost of sales.

the characteristics of high-cost and low-cost-to-serve customers and shows how customer profitability can be increased. The information should be used to persuade high-cost-to-serve customers to modify their buying behaviour away from placing numerous small orders and/or purchasing non-standard items that are costly to make. For example, customer A can be made profitable if action is taken to persuade the customer to place a smaller number of larger quantity orders, avoid special deliveries and reduce the credit period. If unprofitable customers cannot be persuaded to change their buying behaviour, selling prices should be increased (or discounts on list prices reduced) to cover the extra resources consumed.

Customer profitability analysis can also be used to rank customers by order of profitability using **Pareto analysis**. This type of analysis is based on observations by Pareto that a very small proportion of items usually account for the majority of the value. For example, the Darwin Company (Example 10.2) might find that 20 per cent of customers account for 80 per cent of profits. Special attention can then be given to enhancing the relationships with the most profitable customers to ensure that they do not migrate to other competitors. In addition, greater emphasis can be given to attracting new customers that have the same attributes as the most profitable customers.

Organizations such as banks, often with a large customer base in excess of one million customers, cannot apply customer profitability analysis at the individual customer level. Instead, they concentrate on customer segment profitability analysis by combining groups of customers into meaningful segments. This enables profitable segments to be highlighted where customer retention is particularly important and provides an input for determining the appropriate marketing strategies for attracting the new customers that have the most profit potential. Segment groupings that are used by banks include income classes, age bands, socioeconomic categories and family units.