Customer accounting and free return policies of retailers

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Abstract

This case study deals with a retail company. It illustrates how the use of customer accounting can improve its profitability and reshape customer relationships. The case also discusses parameters of appropriate transfer pricing and incentive systems. Students can use this case as an illustrative example in class and use the open-ended questions to reflect on the managerial implications.

Keywords: *Activity-based Costing; customer profitability; target setting; teaching notes; transfer pricing.*

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1 Introduction

SEND is a catalogue-based fashion and decoration retailer. The company sends glossy catalogues to its customers several times a year. Customers can order using a standardized list that they mail to SEND, or via phone. SEND puts a strong emphasis on creating lasting customer ties through extensively long order calls by phone. There, trained phone personnel try to establish a very personal and deep connection to the customer, digitizing information about their lives, such as the customers' favorite leisure activities, or their pets' and family members' names and birthdays. For this, SEND provides a toll-free phone number. Cost of goods sold (COGS) are on average 75% of the retail price. Customers pay by debit card. To match online retailers, SEND offers free shipping, refunds any returns, and even pays for the return shipping charges. Overnight shipping incurs additional processing costs for SEND.

2 Customer Accounting (approx. 40 minutes)

Recently, SEND worries about an increasing amount of manufacturing, selling, distribution and administration (MSDA) costs. SEND currently allocates MSDA costs based on net sales. Now, SEND wants to re-asses its profitability per customer group using activity-based costing (ABC). SEND has clustered the following customer groups:

	Customer Type 1	**Customer Type 2**	**Customer Type 3**	**Customer Type 4**
Gross sales [EUR]	900	1,200	3,200	4,800
COGS [%]	75%	75%	75%	75%
Items returned [#]	-	6	3	36
Items returned [EUR]	-	275	750	2,300
Orders per year [#]	1	7	6	18
Phone orders per year [#]	1	-	-	18
Time spent on phone placing orders [h]	0.50	-	-	9.00
Overnight deliveries [#]	1	-	-	15
Regular deliveries [#]	-	7	6	3

SEND has also discovered the following activity cost driver rates for its MSDA costs:

ACTIVITY	**ACTIVITY DRIVER RATE**
Process mail orders [EUR per order]	9.00
Process phone orders [EUR per hour]	80.00
Process returns [EUR per items returned]	9.00
Process overnight delivery requests [EUR per request]	14.00
Maintain customer relations (send catalogs and respond to customer comments or complaints) [EUR per year]	50.00

Required

1) Analyze the profitability of each customer group (profit and Return on Sales).
2) Explain why the profitability differs among customer groups (three reasons).
3) Advise SEND on three issues how to manage customer relationships.

3 Transfer pricing and alternative approaches (approx. 40 minutes)

SEND's warehouse division (WHD) processes regular orders (REGs) and overnight orders (ONOs) at the order of the sales division (SD). Both WHD and SD are profit centers, and WHD "sells" REGs and ONOs to SD (transfer pricing). For each REG, SD can claim a fictional revenue of 9.00 EUR, and pays a transfer price of 8.00 EUR to WHD. For each REGs, WHD incurs variable cost of 6.00 EUR, and a charge from the IT department of 1.00 EUR. WHD needs 0.05 hours to process one REG, and 0.15 hours to process one ONO. Additionally, ONO requires a 3.00 EUR extra postage fee (paid for by WHD). Overall, WHD has 24,000 hours available for processing orders during the year, and expects to operate at full capacity.

Required

4) What range of transfer prices is feasible for a regular order (REG)? Please explain your answer (one sentence).
5) What should be the minimum transfer price for an overnight order (ONO) if provided at the expense of REG?
6) WHD and SD cannot agree on a final transfer price for ONO. To settle the dispute, WHD asks three established delivery companies (UPS, DHL and FedEx) to offer a price for performing ONOs. They independently agree that an ONO would cost exactly 13.00 EUR. The head of SD, Sam, takes offense at WHD asking for outside bids. Based on his intuition and very long tenure in the company, he thinks that this price is too high. He says that WHD and SD should rather have a friendly chat that continues until everyone is happy. Please argue in favor of WHD or SD, assuming that SEND wants to have "efficient" transfer prices.

4 Incentive systems (approx. 40 minutes)

The head of SD, Sam, receives only a fixed salary so far. The CEO of SEND, Cici, feels that this is not the optimal incentive structure. Cici is the only person in SEND who can make decisions on long-term capital expenditures. She contemplates several options.

Required

7) Cici heard that Residual Income (RI) is supposedly the best measure of performance. But no one at SEND is really an expert on RI. Still, she wonders if she should tie a bonus for Sam to RI. Please comment on two issues.
8) In any case, Cici wants to tie Sam's bonus to a key performance indicator (KPI) of SEND. She is uncertain how this would motivate Sam. On the one hand, a good portion of the merchandize practically sells itself, so Sam would get a "windfall profit". On the other hand, she needs to keep his salary in a range that is acceptable for the other heads of departments. Discuss two options she should consider.
9) Cici is looking for the one, optimal KPI (as a base for the bonus) in the financial statements. What other options does she have (name two)?
10) Cici also considers using a KPI that links Sam's bonus to a group achievement at SEND, or that is a benchmark against SEND's competitors. Sam thinks this is an unfair idea, because this would make his performance dependent on someone else's. Give two good arguments Cici can use to reply.

5 Discussion of the case

A suggested solution is available from the author upon request.

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