

Exploring ridderstrales aim with the account management system



Carl-Erik Ridderstrale, president of Kanthal, was motivated to develop a system to measure customer profitability. According to Ridderstrale, “ we needed an account management system if we were to achieve our strategy for higher growth and profitability. An account management system as a part of the Kanthal 90 Strategy will enable us to get sales managers to accept responsibility for promoting high-margin products to high-profit customers.”

Ridderstrale wanted to move away from the traditional financial accounting categories and found that most of the organizational costs could be classified as either Order-related or Volume Costs. Ridderstrale was attempting to get sales managers to accept responsibility for promoting high margin products to high-profit customers. This would be accomplished as a part of the new Kanthal 90 strategy. The overall goal was higher growth and higher profitability. Ridderstrale wanted to achieve higher growth under Kanthal 90 without adding sales and administrative resources to handle the expected increase in volume. A second goal was to reallocate people and resources to generate future growth. For example, if the company could transform an accounting clerk into a salesman of Kanthal-Super in Japan, the Kanthal could generate a substantial profit increase. Ridderstrale wanted to redeploy people to places where they could earn more profit without eliminating resources in existing steady-state environments. A third goal was to also measure the costs of the individual customer orders placed on the production, sales, and administrative resources of the company. Ridderstrale knew that individual customers made different demands on staff and felt that the new system was necessary to determine how much profit was earned each time a customer placed a particular order. The goal of this

system was to find both “ hidden profit” and “ hidden cost” orders. “ Hidden profit” orders whose demands on the company were low while “ hidden loss” orders are those customer orders that looked profitable but in reality were not. Ridderstrale’s goal was to get more accurate information about Kanthal’s manufacturing cost structure, as well as the costs of supplying individual customers and orders to direct resources to “ hidden profits” and reduce “ hidden losses”.

These goals are sensible. With the new account management system, cost will be properly allocated across different accounting pools. The new cost system will allow Kanthal to identify which high volume customers are actually more expensive to the company and which low volume customers are actually much more profitable than previously recorded. By doing so, Ridderstrale will be able to more accurately identify costs and profits by market, product, and customer.

Why did Ridderstrale feel that the previous cost system was inadequate for the new strategy? Why could there be hidden profit and hidden loss customers with the previous cost system?

The previous cost structure was inadequate for the new strategy because it could show two customers being equally profitable on a gross margin level when in reality there could be hidden costs and or hidden profits present. Resources are equally distributed across all products and customers. They do not measure an individual customer’s profitability or the real costs associated with individual orders. Further, the current cost system records production overhead, selling, and administrative costs as “ fixed”. This is

inadequate because according to Ridderstrale, the definition of strategy is to recognize all costs as variable. Under the previous costs system, indirect costs were manufacturing costs allocated to products based on direct labor or selling and administrative costs that were treated as period expenses. These costs were unanalyzed.

The reason for hidden loss and hidden profit customers is because of the way resources are allocated under the previous cost system. By equally distributing resources, a customer who purchases a high margin product but puts little demand on the company may have hidden profits because too many company resources have been placed with the purchase and vice versa. Hidden profit orders were those whose demands on the company were quite low and included high profit customers who buy high-margin, standard products in large orders.

Hidden loss customers are caused by customers who look profitable under the current cost system but actually demand a disproportionate share of the company's resources to fulfill. This means a customer may purchase low-margin products in smaller volumes. These purchases place very high demand on company resources yet cost associated is equal to the cost of all purchases.

How does the new Kanthol 90 Account Management system work? What new features does it offer? What are the limitations that may limit its effectiveness?

The new Kanthal 90 system was based off information from interviews with all department heads and key personnel designed to discover the nature of <https://assignbuster.com/exploring-ridderstrales-aim-with-the-account-management-system/>

activities being performed by support department personnel and the events that triggered demands for these activities. Kanthal found that most of the organizational costs could be classified as either Order-related or Volume costs. Using information found from the interviewing process, the team determined how much of the expenses of each support volume related to the volume of sales and production and how much related to handling individual production and sales orders. Four distinct categories were established for manufacturing and sales costs. Manufacturing volume costs included material, direct labor, and variable overhead, along with the cost of replenishing inventory. Manufacturing order costs included only those costs associated with the creation of non-stock items. These costs were calculated separately for each product group. Sales order costs were selling and administrative costs which were allocated over individual customer orders. Sales volume costs were allocated in proportion to manufacturing volume costs. The new system worked by allocating the proper costs of each individual order, as opposed to spreading cost equally across all jobs, which meant costs were taken as fixed. The new system treated those previously fixed costs as variable costs.

The features offered under the new system included the separation of costs associated with stocked and non-stocked items. Manufacturing costs were now associated with non-stocked items and left out of stocked items. Order and volume related costs were also treated as separated. Prior to Kanthal 90, there was no distinction between the two.

The new account management system may have limitations that may reduce its effectiveness. The limitations that the new plan contained were linked to <https://assignbuster.com/exploring-ridderstrales-aim-with-the-account-management-system/>

the planning of how a large number of non profitable customers could be treated. In fact, it appeared that two of the most unprofitable customers turned to be among the top three in total sales volume, and if the company decided to allocate them the real indirect costs they will stop buying. This means that the company will have to spread its fixed over a lower number of sales volumes. Another problem was related to the acceptance of the new accounting system by the Kanthal subsidiaries around that conceived this new system as an intrusion of the headquarter management into their operations. All of these limitations may hinder the effectiveness of the new system.

Consider a product line whose products generate 50% gross margin (after subtracting volume-related manufacturing and administrative expenses from prices). The cost for handling individual customer order is SEK 750, and the extra cost to handle a production order for a non-stocked item is SEK 2250.

Compare the net operating profits of the two orders, both for SEK 2000. One order is for a stocked item and the other is for a non-stocked item.

Order 1 generates a profit of SEK 250 for Kanthal because it does not incur the SEK 2250 of manufacturing cost for non-stocked items. This cost of SEK 2250 is the difference between order 1 and order 2.

Using the old system, both of these projects would appear to be equally profitable (or unprofitable). The production order cost for order 2 would be split up among the two orders resulting in a operating loss of (SEK 875). With the new system in place, executives can determine which order is profitable and which is losing Kanthal money.

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Compare the operating profits and profit margins of the two customers, A and B. Both customers purchased SEK 160, 000 worth of goods during the year. A's sales came from three orders, for three different non-stocked items. B's sales came from 28 orders, of which 6 were for stocked items and 22 for non-stocked items.

Profit margins for Kanthal are much higher for order 1 than order 2. This is the result of manufacturing costs of SEK 49, 500 for 22 non-stocked items. The new cost system allocates resources properly showing hidden profits and hidden losses.

Using the old system, Kanthal would allocate the individual order costs and production order costs equally among the two orders. This would increase orders 1's costs (not including COGS) to 39750 SEK's from 9000 SEK's, reducing its operating profits for Kanthal to 40250 SEK's.

It would have the opposite effect on order 2's financials. Total costs (not including COGS) would decrease to 39750 SEK's from 70500 SEK's. This would raise Kanthal's profit from order 2 to 40250 SEK's. The new system correctly illustrates the hidden losses and hidden costs of each customer and order.

What should Ridderstrale do about the two large unprofitable customers revealed by the account management system?

Ridderstrale has a few options when determining what to do about the unprofitable customers. It may not be necessary to cease doing business with them. One option could be to charge an extra fee for non-stocked items.

This would increase revenues on their high volume purchases of mainly non-stocked items. They could also renegotiate with the two large customers in order to attempt to change their ordering habits. This could help eliminate just-in-time delivery and in turn decrease the inventory placed on Kanthal. An extra charge could be placed on the special orders of low-priced items which place high demands on the resources of Kanthal.

Another option may be that Kanthal should stop providing small special orders of low priced products and start charging them for the non stocked items that they used to require during the old accounting system.

Ridderstrale should encourage customers with similar situations to that of the two large unprofitable customers to order large volume of the non stocked products. The sales department should be encouraged to put pressure on these customers to start ordering standard products in large volumes that do not require additional technical or commercial service in advance. This would avoid the fees related to customization and non stocking that they are being charged for in the new system.