

Uncertain Times? Be Certain About What Is Profitable

Best Practices for Managing Cost and Profitability

LIKE NO OTHER TIME in recent history, companies are turning to their finance leaders, asking the question: Where are we profitable? The need to know where the business is profitable—and where it's not—is no longer a quarterly or monthly exercise, but a daily one.

The ability to make informed, quick adjustments to accommodate ever-changing market conditions is a requirement for survival. Finance organizations need accurate, timely insight into the costs and profitability of customers and products in order to confidently identify the true cost and profit drivers in their business.

This sponsored white paper explores why an effective cost and profitability system (CPS) can help you answer the profitability question today—and improve your company's performance tomorrow.

ABC vs. Standard Costing

Since its introduction in the early 1990s, activity-based costing (ABC) has been the subject of much acclaim, and has also received its share of criticism. While ABC's popularity grew, it still is not as widely used as standard costing, particularly in the production function of the value chain. Standard costing allocates indirect costs based on standard indirect-cost rates and volume. ABC accumulates resource costs into activity-cost pools and allocates activity-cost pools based on output measures consumed by cost objects.

Although detractors maintain that ABC is too complex and cumbersome to justify its use, research shows that when used in conjunction with a cost and profitability system, the methodology can provide significant value to managers and help companies allocate resources more accurately and realistically to better understand their costs and profitability, and ultimately improve the bottom line.

The Three R's of Good Costing

For more than a decade, the Business Research and Analysis

Group (BRAG) has conducted research on practices related to performance management, including cost and profitability systems. From March to November 2008, BRAG conducted an online survey of more than 400 organizations worldwide to assess the extent to which organizations realize benefits from cost and profitability systems.¹

Costing accuracy appears to be the most significant concern among respondents, according to William O. Stratton, Ph.D., CMA Professor of Accounting, The Udvar-Hazy School of Business, Dixie State College of Utah, one of the architects of the survey. "To be accurate, allocations must be relevant, reliable and reasonable—those are the three 'R's' of good costing," he explains. "Cost allocations need to make sense, have a valid cause-effect relationship, and pass the cost/benefit test."

ABC Is a Clear Winner

Despite their concerns about accuracy, survey respondents were generally enthusiastic about ABC and cited many tangible benefits, including better decision support, improved profitability analysis, easier budgeting and planning, and the ability to control costs and make operational improvements.

But how can respondents agree with so many benefits when there is a lack of "accuracy" in assigning activity and overhead costs to products or services?

VIEW THIS ON-DEMAND WEBCAST FEATURING:

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“In many cases, costs are simply not measured or not assigned to products or services,” Stratton explains. “With the exception of production-related costs, a significant proportion of costs are not assigned to cost objects—products, services, and customers. But contrary to a common belief, ABC is not a production-specific method: ABC methods can be used across the entire value chain.”

So if ABC is such a clear winner, why isn't it used more often?

“Unfortunately, it often comes down to a lack of senior management support,” says Stratton. “However, our survey results refute claims that ABC is often abandoned. Only 3 percent of the organizations we surveyed had previously used ABC but no longer use it—the vast majority of ABC systems that have been deployed are still in place.”

Best Practice Companies: A Comparison

A primary objective of BRAG's study was to discover the best practices in cost and profitability measurement of successful organizations. “We identified ‘best practice’ organizations—those that had realized significant benefits from their CPS,” says Raef A. Lawson, Ph.D., Vice President of Research and Professor-in-Residence, Institute of Management Accountants (IMA), another of the survey's architects. “We found some major differences between those companies and companies using only standard costing.”

The survey identified the following improvements in organizations that had used a CPS to provide useful information for managerial decision-making for at least one year:

- **Accurate identification** of which customers are profitable and which are not

- **Able to provide cost information** at all necessary levels (customer, product/service, key processes, key activities, etc.)

- **More accurate calculation of channel, product, and regional cost**

- **Able to calculate the proportion of resources** consumed by each customer type and/or individual customer

- **More accurate reporting of cost behavior** (e.g., fixed and variable cost characteristics)

- **Improved traceability** of cost allocations

- **Better ability to handle** reciprocal costing

- **Timely data integration** (data is always up-to-date)

“The fact is that most best-practice organizations are using ABC,” says Lawson. “These companies know that using activity-based costing helps them understand their operations, improve processes, and control costs better than standard costing alone. But detail is necessary to reap these benefits—companies must have an appropriate number of activities and cost objects identified in their CPS.”

Considerations for a CPS

Companies that are looking to implement a cost and profitability system should make sure that the systems they're considering can reliably provide ongoing, relevant results in a reasonable manner—Stratton's three “R's.” Key to this capability is a fourth “R”: reporting. Flexible reporting capabilities are important to produce defensible results that support business decisions.

As previously mentioned, building and maintaining the system must be reasonable, and allow for continuity of meaningful results as the business

organization is adjusted. Look for a system that will reduce dependency on IT professionals for building and maintaining models, and allow business users to define the assignment of costs—let the technology generate the background calculations.

Companies should look for a system that offers user-controlled model validation and data loading, with predefined validation reports. Reports should present “actionable” results in a variety of forms, including trend reporting, scenario results comparison, and dashboarding, and allow for ad-hoc drilldowns and data analysis.

Oracle's Profitability and Cost Management Solution

Profitability and Cost Management is a key component of Oracle's Enterprise Performance Management System. Oracle Hyperion Profitability and Cost Management (HPCM) provides flexible methods for transforming costs and revenue from accounting sources, including multiple stages of cost and revenue assignments. The solution also supports a wide variety of costing methodologies.

With Oracle HPCM, companies can gain confidence in cost allocations and revenue flows with graphical traceability maps, and can quickly validate models with user-defined business rules. Users can also define up to nine stages of transformations via an easy, template-driven approach. Oracle HPCM can handle reciprocal costing with ease, and is designed to integrate with other management decision systems.

Using Oracle HPCM and activity-based costing, companies can answer the profitability question with confidence—and use that information to bolster the bottom line.