
Activity-Based Management in Wholesale Distribution: Successful Integrated Supply Relationships

Steve Player and Jim Gibson

EXECUTIVE SUMMARY

- Wholesale distribution companies are the sole link that many manufacturers have to certain markets, and the means by which many manufacturers create and nurture relationships with their customers.
- As a result, many wholesaler-distributors now provide new services to help their clients. Often these are services that clients once performed for themselves.
- Consequently, while the movement of goods is the primary purpose of wholesale distribution firms, they inevitably offer marketing, financial, and logistical support to suppliers and customers.
- Wholesale distribution firms must understand the activities required to deliver these new services for clients—and what those activities ultimately cost.

Much has been written and said in recent years about the need for wholesaler-distributors to think of their customers as individual market segments, customizing services and service levels to the needs of each customer. Many firms have adopted this way of thinking, consulting with their customers to create new value-added services. But because so many of these services are based on performing activities—in some cases activities that the customer once performed—this new approach has created a heightened need for wholesale distribution firms to understand what it costs to deliver these services.

According to the 1995 Distribution Research & Education Foundation research study of the National Association of Wholesaler-Distributors (NAW) entitled *Facing the Forces of Change—Trans-*

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forming *Your Business with Best Practices*, the pace of change in wholesale distribution is accelerating. The combination of a variety of trends probed in this study include the following:

- Downward pressure on gross margins.
- Proliferation of highly customized, value-added services for channel partners.
- The evolution of integrated supply relationships.
- Customers' demands for fee-for-service pricing.

Distributors, including *maintenance, repair, and operations (MRO)* distributors, now perform activities once executed by their channel partners.

Some wholesaler-distributors are also outsourcing activities such as logistics and warehousing to other participants in the supply chain or to third-party providers. Thus, the need for good management information, including a thorough understanding of the underlying contributors to the overall cost structure, is paramount.

ACTIVITY-BASED METHODS

Facing the Forces of Change found that the use of *activity-based costing (ABC)* and *activity-based management (ABM)* was relatively low in the wholesale distribution industry. Yet it also found that those companies that had implemented some form of ABC had higher return on total assets (ROTA) than the ROTA of companies that had not adopted ABC.

As part of a balanced approach to performance management, ABC and ABM address some of the typical deficiencies found in many wholesaler-distributors' management information systems. When conceived, designed, and executed well, ABM systems give wholesaler-distributors the tools and information to:

- Understand customer and product profitability.
- Identify cost improvement opportunities.
- Evaluate the cost of value-added services.
- Screen profitability potential for new customers.

Importance of Activity-Based Management

The current surge of interest in ABM began in the mid-1980s. Its usage within and outside the wholesale distribution industry has grown as companies understand its power. In many organizations, activity-based initiatives are in their second or third phases, enhancing areas of operation that were never considered several years ago. For these companies and others that have progressed even further, ABM has become standard operating procedure.

Advocates point to one overriding reason for the growing use of activity-based practices across American industries: ABC exposes the hidden costs and complexities in business and provides ways to measure them. ABC helps management understand what goes on in their companies, what it costs, and where the impact occurs.

Traditional cost systems were characteristic of this century's approach of focusing on financial management. This historical approach focused on reporting dollars consumed in an effort to arrive at the cost of doing business. ABC and ABM deepen that focus by addressing the underlying physical activities that drive cost, thus giving companies a more comprehensive platform for managing them. Today's ABM systems go beyond knowing who you paid by providing information on what work was performed and the value that the work created.

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SUCCEEDING WITH INTEGRATED SUPPLY RELATIONSHIPS

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This trend over the last decade has led to development of various forms of integrated supply relationships within the industrial supply channel. While the mechanics of how these relationships operate vary significantly, these relationships revolve around two major operating principles:

- An end-user (manufacturer or service company) dramatically reducing the number of vendors or distributors used to supply them with MRO items, such as replacement electrical components, lubricants, safety equipment, hand tools, janitorial supplies, and other items not directly involved in the manufacturing or service delivery process); and,
- End-user outsourcing of various functions or activities involved in the procurement and management of MRO inventories to one or more of the remaining vendors or distribution partners over the term of a multiyear contract.

Benefits to End-Users

The incentives for the end-user in this type of relationship include:

- Elimination of a wide range of activities they once performed related to MRO inventories (with a corresponding reduction in internal activity cost);
- Possible transfer of ownership of these inventories until actual consumption to the integrated supply partner(s); and,
- Reduced complexity associated with dealing with fewer MRO vendors or distributors.

Benefits to Vendors and Distributors

Vendors and distributors who are chosen as the integrated supply partner(s) benefit in many ways:

- Protection of the business they have historically had with this customer;
- Possibly increased sales to the customer through sole-sourcing or expansion of products supplied to the customer; and
- Generally increased gross margins for products supplied under this relationship to compensate the integrator for the additional activities they will be performing with this new relationship.

The Role of Activity-Based Information

Activity-based information is critical for both channel members as they enter into this relationship and as a tool to measure the benefits derived from this new arrangement.

Activity-based cost information can (and should) be used by the end-users so that they fully understand and quantify the cost of the activities they are currently performing related to MRO procurement and inventory management. This type of information can be used by the end-users to estimate the benefits they can expect to derive from outsourcing some or all of these activities.

ABC information is also equally critical for the distributor who will become the outsource provider of these services. Armed with this knowledge, the distributor will be better able to negotiate a contract with the end-users that is beneficial and fair to both parties.

Without ABC information, the distributor may discover too late that the costs associated with living up to the customer's expectations under the contract far exceed their estimates and make it a losing proposition. Activity-based information can also be used once an integrated supply relationship is established to monitor actual cost savings or profit improvement for both parties and to set goals for further improvement in future years.

Forging Mutually Profitable Relationships: A Success Story

The experiences of TTI, Inc., an electronics distributor in Fort Worth, Texas, illustrate how an ABM tool can be successfully applied in an integrated supply-like setting.

TTI has offered an automatic replenishment program to customers since the early 1990s. Up until the development three years ago of an ABC tool that illustrates and quantifies the benefits of automatic replenishment to customers, TTI had been moderately successful in signing up customers under this program (10 customers, \$7 million in combined sales).

A comparison of the activities performed by a customer under the traditional relationship (standard vendor/customer relationship) and under the automatic replenishment program with TTI is illustrated in Exhibit 1.

Comparing Unit Costs

TTI, with assistance from Arthur Andersen, developed an ABM tool that, with a limited amount of data input by the customer into

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Exhibit 1. TTI's Automatic Replenishment Program

Customer Activities Under a Traditional Relationship With TTI	Customer Activities Under TTI's Automatic Replenishment Program
<ol style="list-style-type: none"> 1. Complete planning schedule 2. Plan orders based on manufacturing schedule 3. Prepare purchase orders to TTI and release 4. Monitor purchase order status 5. Receive and report incoming supplies from TTI 6. Match packing slip and purchase order 7. Store materials in warehouse 8. Operations requests products 9. Pick products and move to work area 10. Record movement 11. Receive invoices from TTI 12. Match purchase order, invoices, and receivers 13. Code and input invoices 14. File invoices 15. Print and mail checks to TTI 	<ol style="list-style-type: none"> 1. Complete planning schedule 2. Electronically receive incoming material and move to work area 3. Print and mail checks to TTI

the template, enabled the customer to model its own activity-based costs of purchasing TTI's products based on the 15 steps or activities in Exhibit 1. The results of this analysis regularly showed that the per unit cost of the 15 activities identified above actually *exceeded* the per unit cost of purchasing the product from TTI (average of \$0.13 per unit activity cost versus \$0.10 average unit cost for the manufacturer's products).

With the information provided by TTI's ABM tool, it became evident to customers that it would be a significant savings, *on a total delivered cost basis*, to switch to TTI's automatic replenishment program.

Customers who opt for TTI's automatic replenishment program pay a slightly higher per-unit price for TTI's products—an average

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of \$0.12 per unit rather than the \$0.10 per unit of buying directly from the manufacturer. This premium of \$0.02 compensates TTI for the added activities, such as purchasing, inventory stocking, etc., that TTI performs on behalf of the customer.

Note that TTI—because of its economies of scale, process simplification, and enabling technology—can perform the activities previously performed by its customers at a substantially lower cost. While customers of the automatic replenishment program must still perform a few activities, the average *total delivered cost* for the customer is ordinarily substantially lower than it would be otherwise. This cost is about \$0.14 per unit for customers of the automatic replenishment program (that is, the \$0.12 TTI charges plus about \$0.02 the customer incurs to perform the remaining activities). This compares favorably with the total delivered cost under a traditional relationship of buying direct from the manufacturer (that is, the \$0.10 apparent manufacturers unit charges plus the \$0.13 in hidden costs the customers incur to perform the 15 activities themselves).

Proving the Benefits and Cost Savings

TTI's automatic replenishment program has been wildly successful over the past three years. The number of customers has increased to a total of 50, and sales have grown to over \$100 million annually. As Craig Conrad, TTI's Vice President of Sales, says:

Allowing the customers to quantify the costs and benefits using their own numbers eliminates much of the emotion from this decision. This has led to a dramatic increase in our revenues from the use of this tool.

In addition to attracting new customers with this tool and program, TTI has also increased its share of business received from existing accounts. Customers who used to deal with a number of suppliers now deal only with TTI, which is responsible for the customer's entire electrical components inventory.

TTI was able to successfully convert its ABM tool into a marketing advantage. The ABM tool helped customers understand the cost of performing activities that TTI could perform more efficiently and also provided a solid basis for negotiating the terms under the new automatic replenishment program.

The application of this approach and management technique to the industrial supply channel in the context of integrated supply relationships is obvious. Industrial distributors should seize the opportunity to better understand their costs and avoid entering into new supply arrangements with customers who don't adequately compensate the distributors for the new activities they perform.

“How fast you go is not as important as making sure you are on the right road.”

THE FUTURE FOR WHOLESALE-DISTRIBUTORS

As an old saying goes, “How fast you go is not as important as making sure you are on the right road.” This is especially true in

understanding the management of costs and how to implement ABC and ABM systems.

Wholesaler-distributor CEOs also are being converted and are speaking out about ABM. For example, Brent Grover, president of National Paper & Packaging Company in Cleveland, initiated a process to better understand the key factors driving the company's cost and profit structure. According to Brent, "We wanted to identify those customers who were less profitable than others and work with them to change that. Vendors and customers want to do business with distributors who understand their costs."

After many years of worthwhile implementations, ABM is here to stay. Because it works, wholesaler-distributors are making ABM the heart of their decision support systems. Its use is expanding into many areas, including monitoring the cost of value-added services and new supply arrangements, like integrated supply. ♦

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REFERENCES

Player, R.S., and Gibson, J. *Activity-Based Management in Wholesale Distribution: Winning the Profitability Battle*. Washington, DC: National Association of Wholesaler-Distributors, 1997.