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ABM – TORQUAY Ltd.

TORQUAY Ltd.'s consultants suggest to charge passengers 190.00 EUR for a (each) re-scheduled trip. Furthermore, they suggest transferring the advertising activities (flight offers) to a Marketing agency. The agency would charge the customer 100.00 EUR per offer. Accordingly, they want to cut total costs by 15 % in the Ticket Sales Office and reduce the ticket prices by 3 %. We consider for ABC a 6 : 2 ratio for Ticketing and Re-scheduling costs. There are no cost allocations for Advertising. The question is, whether TORQUAY should make these changes. To support the decision, TORQUAY Ltd. runs an ABM analysis considering suggested cost cuts and activity changes. The decision depends on the total of profits. This example is a typical situation in ABM. To assess the new plans, TORQUAY Ltd. prepares an alternative cost plan variant.

The cost calculation starts in the Ticket Sales Office cost centre. Its total costs are: (1 – 15%) × 2,000,000 = 1,700,000.00 EUR/m*. The costs are split at a 6 : 2 ratio, which assigns: (6/8) × 1,700,000 =* 1,275,000.00 EUR/m *to Ticketing and: 1,700,000 – 1,275,000 =* 425,000.00 EUR/m *to Re-Scheduling. Observe the changes in the process cost rates shown in Figure 1.*

Cost pool	Costs	CD	PCR
Ticketing	1,250,000	17,500	71.43
Rescheduling	425,000	1,600	265.63
Advertising	0		

Figure 1: TORQUAY Ltd.'s alternative activity analysis

The profitability analysis now is based on the adjusted ticket prices. The revenue decreases by 3 % and then becomes equal to: 2,400,000 × (1 – 3%) = 2,328,000.00 EUR/m *for the Europe route and 10,350,000 × (1 – 3%) =* 10,039,500 EUR/m *for the FarEast route. The Re-scheduling fees amount to 190.00 EUR/re-scheduling. According to the values, there is revenue from re-scheduling fees for the Europe route of: 500 × 190 =* 95,000.00 EUR/m*. The fees for the FarEast route are: 1,100 × 190 =* 209,000.00 EUR/m*.*

The alternative profitability analysis is disclosed in Figure 2. The total profit for both routes are: 322,817.88 + 1,653,682.12 = 1,976,500.00 EUR/m*. Before it was 1,730,000.00 EUR/m. The question is whether TORQUAY Ltd. must run an alternative profitability analysis for making the decision. The answer is no, as the total of profits does not change with the allocation of costs.*

	Europe	FarEast
Revenue	2,328,000	10,039,500
Reschedule fees	95,000	209,000
direct costs:		
- Check-in expenses	(720,000)	(1,380,000)
- Fuel expenses	(600,000)	(2,100,000)
ABC:		
- Ticketing	(428,571)	(821,429)
- Rescheduling	(132,813)	(292,188)
- Advertising	0	0
Overheads	(218,798)	(4,001,202)
Net operating profit	322,818	1,653,682

Figure 2: TORQUAY Ltd.'s alternative profitability analysis

An ABC here only is required to assess the process cost rates. The Accountant and the Ticket Sales Office manager must decide whether the process cost rates for the activities are acceptable. As the cost rates are higher than before, Ticketing and Re-scheduling have more resources available for their activities. We summarise this situation as follows: the Ticket Sales Office employees got an easier job but TORQUAY Ltd. is losing money. TORQUAY Ltd. should not follow the consultants' advice.

TORQUAY Ltd. makes another change to its business concept and now cuts costs in the Ticket Sales Office by 25 %. In this case the process cost rates for the activities drop below the previous levels, as shown in Figure 3.

Cost pool	Costs	CD	PCR
Ticketing	1,125,000	17,500	64.29
Rescheduling	375,000	1,600	234.38
Advertising	0		

Figure 3: TORQUAY Ltd.'s process cost rates, 2nd amendment

Now, the employees in the Ticket Sales Office get less resources (less time) for their work. Less resources means for example, there is one officer less answering the hotline and the remaining colleagues must take over her/his calls.
The question of whether the higher workload works out for the department, cannot be answered by Accounting. The Accountant only computes the process cost rates. The decision about the acceptance of the minimum of process cost rates is subjected to decisions made by department management. The manager must decide whether the workers can manage the higher workload. The process cost rate tells how much costs/resources are assigned to a one-time-execution of one ticketing or re-scheduling activity. In many

affiliated companies the process cost rates can be compared between divisions. If the process cost rate in one department is doable, it seems possible to run the activity at that same rate somewhere else.

TORQUAY Ltd. decides to go for the 25 % cost cut in the Ticket Sales Office and measures the profit for both routes thereafter. Observe Figure 4:

	Europe	**FarEast**
Revenue	2,328,000	10,039,500
Reschedule fees	95,000	209,000
Direct costs:		
- Check-in expenses	(720,000)	(1,380,000)
- Fuel expenses	(600,000)	(2,100,000)
ABC:		
- Ticketing	(385,714)	(739,286)
- Rescheduling	(117,188)	(257,813)
- Advertising	0	0
Overheads	(218,798)	(4,001,202)
Net profit	381,300	1,770,200

Figure 4: TORQUAY Ltd.'s profitability analysis, 2nd amendment

The total profit equals: 381,300.02 + 1,770,199.98 = 2,151,499.00 EUR/m *and exceeds the previous and the initial amounts. TORQUAY Ltd. should go for the changes.*

We see that the profit relationship between the routes has changed. Under the initial profitability analysis, the profit ratio was 44% : 56% as Europe : FarEast. After the application of ABC, it became 7% : 93% and after the cost cut following the second suggestion, it is 15% : 85 %. The latter change about the profit portions is caused by the price cut and shows in the revenues. A 3 % price cut on the FarEast route means: 10,350,000 – 10,039,500 = 310,500.00 EUR/m*. This is more than on the Europe flights. At the same time, the costs are changed for both routes to the same extent. This results in an imbalance of profit changes.*

A further aspect to be taken into consideration is the Marketing perspective of the product changes. An ABM that changes business processes the customer does not see, does not worry us. However, here TORQUAY Ltd. changed the price and re-scheduling terms. Both is visible to the passengers. The Marketing director is in charge to check whether these changes have an impact on the customers' booking behaviour as TORQUAY Ltd. competes with other airlines on the same routes.