Customer Profitability Analysis

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Abstract

This paper describes the insights gained from well-grounded methods of measuring customer profitability and how organizations can apply customer profitability analysis to actively manage changing strategies to increase profit, reduce cost and improve performance throughout an organization.

Key words: *customer profitability analysis, performance management, cutting costs*

Introduction

Every executive, CEO's, CFO's, or salespeople must answer the following questions:

o   Who are the most profitable customers?

o   Who are the losing customers?

o   What percentage of customers is profitable?

If a distributor cannot answer these questions, or worst, if he does not know how to define customer profitability, then he puts his company's overall profitability at risk.

Today, we need to know more than the profitability of Balance Sheet assets - we also need to know the profitability of our customers. Knowing the profitability of customers, we can:

o   Decide where and how to allocate resources;

o   Focus marketing activities;

o   Change selling practices;

o   Offer and assess services;

o   Negotiate pricing and contracts.

This article focuses on measuring and evaluating the profitability of individual customers and groups of customers. "Real" customer profitability analysis goes far beyond sales and gross profit analysis by customer - real customer profitability analysis drives customer profitability to the "bottom-line" of a P&L statement for each of your customers and customer groups. Modern accounting methodology, mainly Activity-Based Costing and Information Technology's business intelligence tools give the ability to measure direct customer profit.

Not All Customers Are Equal

Some customers purchase a mix of mainly low-margin products. After adding the "costs-to-serve" for those customers apart from the products and service lines they purchase, these customers may be unprofitable to a company and to that company's extended value chain. Other customers who purchase a mix of relatively high-margin products may demand so much in extra services that they also could potentially be unprofitable. How does one properly measure customer and supplier profitability? How does one deselect or "fire" a customer or a supplier?

After the less-profitable customers and suppliers are identified, they can be migrated towards higher profits using "margin management" techniques.

If two of your customers purchased exactly the same mix of products and services at exacly the same prices during the same time period, would both customers be equally profitable? Some customers place standard orders, whereas others demand non-standard everything, such as special delivery requirements. Some customers just buy your product or service line, and you hardly ever hear from them. Others you always hear from - and it is normal to change their delivery requirements, inquire about and expedite their order, or return or exchange their goods. Some customers require more post-sale services than others do. In some cases, just the geographic territory the customer resides in makes a difference.

If we added up all the costs of our time, effort, interruptions and disruptions attributed to those customers, in addition to the costs of the products and base service lines would we find out that we really made any profit? How do we know the level of profitability of any or all of our customers? Most organizations do not.

Customer Profit Statement

The basic financial document for reporting corporate profitability is the P&L Statement.

The Customer Profit Statement starts with the Net Sales to the customer for the period - a month, quarter, or year. The Gross Profit for the customer is generated by your financial accounting system. Sales and Gross Profit are the easiest numbers to generate by customer and the "profit" line where most customer profitability analysis ends.

Direct Operating Expenses by customer are produced by an Activity-Based Costing (ABC) system. ABC is a relatively new cost accounting methodology that tracks operating expenses from the G/L to customers and/or to products. Historically, ABC was developed to perform product and process costing in manufacturing operations. ABC has more recently been applied to "cost-to-serve" modelling in wholesale distribution. It is in the context of determining the cost-to-serve individual customers that ABC is used to determine the Direct Operating Expenses attributed to a specific customer.

As an example, applying ABC to the delivery process determined the Delivery Expense attributed to the customer in table 1. First, ABC was used to find the cost to make a delivery on customer's route. Second, this ABC determined number was multiplied by the number of deliveries made to customer during the period to arrive at the Delivery Expense to serve the customer.

The Cost of Capital shown in table 1 is driven by the customer's average Accounts Receivable balance during the year. Traditional financial management techniques may be used to determine your company's cost of capital.

The Direct Operating Expenses and Capital Cost are summed and subtracted from Gross Profit to arrive at Contribution. The term "contribution" comes from the fact that these are the customer's contributions to the company's overhead expenses, that is, to those expenses that

haven't been directly traced to customers. Many of these expenses fall under the General and Administrative Expense category, although it is the purpose of ABC to assign as many of these expenses as possible to direct operating expense categories. A positive Contribution means that the customer is contributing to overhead expenses and profit.

Table 1. Customer Profit Statement

Net Sales	1.000.000
Gross Profit	200.000
Direct Operating Expenses	
Handling	8.000
Storage	7.000
Sales	38.000
Customer Service	47.000
Delivery	45.000
Capital Cost for A/R	9.000
Contribution	46.000
Business Management Expense	25.000
Customer Profit	21.000

Frequently, the analysis stops at the Contribution line. ABC attempts to assign all expenses, especially those in the G&A category, to customers so Contribution is usually a good measure of customer profitability.

In table 1, we have chosen to allot all of our expenses to customers, both direct expenses and overhead expenses. We have taken all the G/L operating expenses that could not be directly assigned to customers and put them into a cost pool called Business Management Expense. We then alloted these expenses to our customers based on an overall driver of costs in the organization (example: the number of invoice lines). The basis for alloting Business Management Expenses depends on the distribution industry and on the extent to which the activity measure tends to increase (and decrease) overhead expenses in your company. For example, in the service merchandising or tobacco distribution industry, you might use the number of stores served; in the chemical distribution industry, the number of gallons processed; in the metal service centre industry, the number of tons processed; or in many other distribution industries, the number of invoice lines handled. When Business Management Expenses are alloted to the customer, they are usually alloted according to the extent in which the activity tends to drive-up organization costs.

Customer's allocated Business Management Expense is subtracted from their Contribution to arrive at Customer Profit (sometimes called Direct Customer Profit). In table 1, customer's Contribution and Customer Profit are positive suggesting that it is a profitable customer.

Customer Profitability Analysis

The real benefit in building Customer Contribution Statements, measuring customer performance, and calculating customer scores is using the information to improve the profitability of individual customers or customer groups. Knowing the profitability of your customers, you can work with your salespeople to reward the "winning" customers and to change the behaviour of the "marginal" and "losing" customers.

Many companies categorize their customers accordin to their geographic location, their demographics or their shopping behaviour. These categories are useful for sales and marketing studies, but the understanding of customer-related costs requires "value segmentation".

Customer Profitability Analysis will allow you to classify your customers and differentiate your services and prices to them. Based on your customer-scoring model, for example, you might identify a group of "Premium" customers. Premium customers receive special treatment such as anytime delivery or immediate answer, customer service phone numbers. At the other end of the customers range we might have a group of customers who pay delivery charges and receive no special treatment. Those loyal customers, who shop on service and quality, paying us for the value we bring to them, are treated like "Premium"; while those customers who constantly buy on price are treated accordingly.

We mostly read about and practise only product differentiation - customer profitability analysis allows us to practise customer differentiation. More importantly, it is a tool that allows us to improve our overall corporate profitability at the customer level.

Information Technology Solutions

The methods of Customer Profitability Analysis could not be implemented without today's information technology. The data and computational requirements of activity-based costing and customer profitability analysis quickly exceed what is typically available with most accounting and management information systems. G/L and accounting systems were never designed for managerial accounting applications and individual customer profitability analysis.

The possible solutions for Customer Profitability Analysis include:

o   data base management systems and spreadsheets;

o   on-line analytic processing (OLAP) software;

o   data warehouses;

o   dedicated Customer Profitability Analysis software.

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Analiza profitabilității clienților

Rezumat

Articolul prezintă avantajele evaluării profitabilității reale adusă de clienți şi modul în care organizaţiile pot aplica strategiile de creştere a profitului, de reducere a costurilor şi de îmbunătăţire globală a performanţei folosind analiza profitabilităţii clienţilor.