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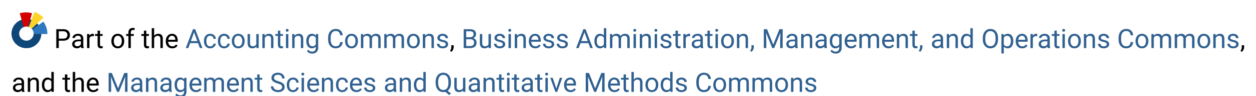
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"We lose money on every sale; we make it up on the volume" is a weary joke, but it's still true of too many companies' operating philosophy today, says the author, in recommending thoroughgoing—

CUSTOMER PROFITABILITY ANALYSIS

by Merritt J. Davoust
A. T. Kearney, Inc.

TODAY'S struggle with shortages, rising costs, and frozen prices may be obscuring a more fundamental problem that has been growing in importance in recent years. For some time we have been hearing about companies whose sales have continued to increase but whose profits have declined. It was becoming more and more apparent, even before the current crisis, that many companies are wrestling with the problem of long-established plants or products that are not achieving targeted profit goals. And, in many cases, management is finding that the time-honored solution of increasing volume is not producing the desired results.

Why? Surely the basic "principle" of increasing sales to improve profits is still sound! Strangely enough, many companies are discovering that more volume is not the answer to missing profits. Even more strangely—there often appears to be a correlation between present unsatisfactory results and past successes in "maintaining share of market." Rank heresy? Not really—just the cold hard economic facts.

And "facts" are often at the root of the problem—accounting facts. As companies and volumes grew, the more it became necessary for the accountants to find suitable methods of "averaging" those costs not directly identifiable in the product. As business organizations became more complex, greater emphasis was placed on timely information, properly subdivided according to organizational needs, being made available on a tight time schedule.

These pressures shaped the basic objective of today's typical accounting system—the matching of costs and revenues within a particular time frame. In recent years, the accountants have regularly developed additional analytical tools to assist in the ever-increasing complexities

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of dynamic decision making. Responsibility accounting, breakeven analyses, direct costing, and variance analysis are but a few. In general, these tools were developed to fit specific organizational requirements and have continued to accept the premise that all customers are "average" customers.

But, instead of helping management pinpoint profit opportunities, these accounting approaches can often camouflage the real problems.

This is so because the improvements in the accounting system have tended to be product-line or manufacturing-plan oriented rather than customer-type oriented. In addition, the drive to increase volume at all costs has often meant tapping marginal customers or sales territories. Sales volume has gone up but total profit has gone down as a result, since each additional sale means increased direct production costs. If the profit from the sale—taking into account all the time spent in making it and the time spent in making deliveries—is lower than it is for better customers, the net result is going to be lower overall profitability for the product even though total sales volume figures show an increase.

In recent years, increasing emphasis has been placed on the concept of integrated physical distribution. This has helped to identify the fact that many cost accounting systems have taken only a cursory peek beyond the factory door and have, traditionally, lumped together a significant portion of total costs as part of "indirect overhead." It has also helped to make management more aware of the cost impact of different customer characteristics.

In the first place, nearly all the costs beyond the factory are not fixed nor are they indirect. They are the direct result of the mix of customers and their order profiles and the marketing, distribution, and service policies of the company. The key point is that they are usually direct, variable costs when measured against the source of revenues—namely, the customer.

More and more companies are discovering the value of a profitability accounting system that matches costs and revenues by *source*—rather than by time period.

Are we talking about significant costs? Recent studies show that the percentage of the sales dollar that is most heavily influenced by customer characteristics exceeds 20 per cent in many manufacturing industries and ranges even higher in

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Instead of gathering costs, develop a method of flowing costs *forward* . . .

most service industries. At these orders of magnitude, it is clear that management needs better information about the differences in "customer costs" and a system that permits determination of profitability by types of customers' characteristics.

This knowledge can serve management needs in several ways:

1. Establishment of organizational goals based on the identification of the inherently most profitable business mix.

2. Formulation of specific, customer-oriented marketing strategies to achieve this mix.

3. Development of optimum integrated distribution systems taking full advantage of trade-off opportunities.

4. More accurate financial planning.

Profit improvement opportunities available through the reshaping of the inherent profitability of the business mix are generally many times greater than those available from improved efficiency alone. In most systems of profit accountability, some organizational units (usually plants or product managers or sales groups) are measured as profit centers. The accounting system essentially flows revenues and costs *back* to the organizational unit and attempts to properly match them within a specified accounting period. However, meaningful decisions are difficult to make in dealing with an unprofitable profit center since it is actually an agglomeration of all the individual profits or losses derived from each and every customer transaction in which its products were involved. Thus, to effect a significant improvement in the inherent profitability of an operating unit, it is necessary to identify those individual pieces of business that are not profitable. Steps can then be taken to attempt to raise these to acceptable levels. If, after consideration of such key factors as product mix, sales coverage, pricing, order profiles, and distribution costs, it is determined that some customers cannot be converted into sources of profit, you can begin systematically to de-emphasize the specific source of loss. At the same time, a properly constructed system will permit the development and application of revised marketing and distribution strategies more specifically tailored to the inherently more profitable segments of the market.

In effect, this is saying: reverse the flow of cost information. Instead of gathering costs, develop a systematic method of flowing costs *forward* to the revenue source so that a clearer picture can be achieved as to the real sources of profit. A customer profitability analysis program rests squarely on the availability of key cost information developed in readily usable form. This generally requires a basic cost building block approach in which the first step is the:

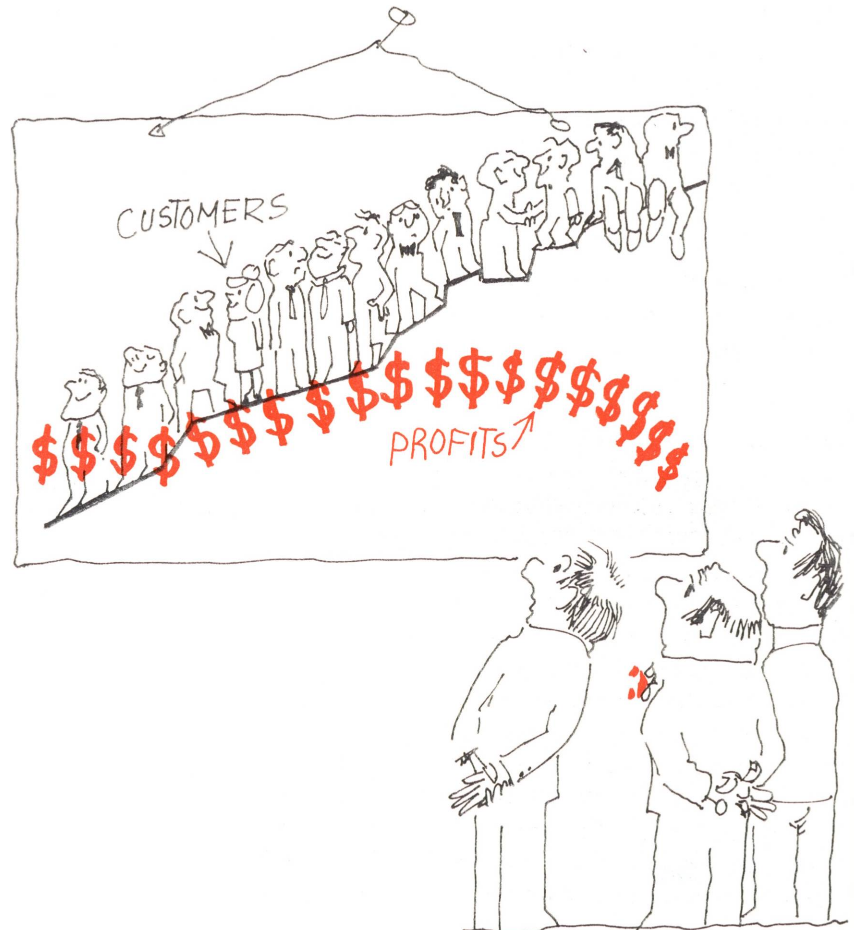
1. Segregation of each cost pool.

2. Identification of the factors that cause those costs.

3. Development of cost per unit factors.

4. Determination of the appropriate ranges of applicability.

It is this step which most often takes the most time, the most ingenuity, and the greatest reshaping



As the number of customers goes up, the profits can easily decline.

of the company's traditional accounting records, because customer-related costs do not fit into established organizational responsibility patterns. For many years, the sheer size of this task may have scared off many companies who continue to wonder why they are regularly in the bottom half of their industry in terms of profit per dollar of sales.

The rewards, however, can be worthwhile. Recently, a major distributor of paper and related products completed a detailed analysis of costs and profitability in a sales region. The area selected was one that had experienced increased sales volume but decreased profits. The results were eye-opening. Salesmen were making hundreds of face-to-face calls on customers where the gross margins did not pay for the cost of the call, the processing of the order, and the delivery of the product. The company had overachieved a goal of having the best sales coverage in the industry. Armed with new customer profitability information, this company was able to improve profit by 25 per cent by systematically adjusting sales coverage and revising its operating methods. Steps are now under way to apply customer profitability analysis to the entire company with a practical expectation of several million dollars of additional profit. While it is true that a great deal of detailed information must be handled, the availability of computer-based order entry and invoicing systems makes feasible the development and utilization of this important approach to profit management.

An approach that worked

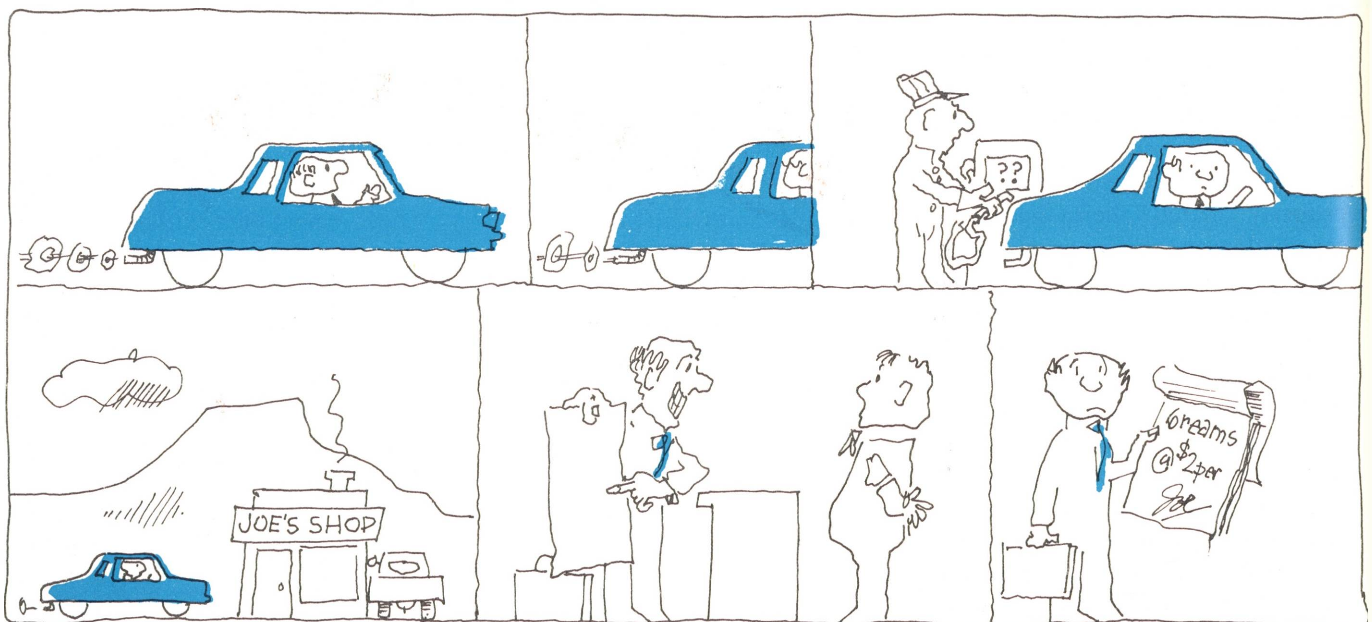
Here is a practical approach for the use of customer profitability analysis as a tool to "reshape" the business mix into the inherently most profitable configuration. You might call it a "vertical boring."

The purpose is to take an appropriate slice through the entire business operation in order to establish the methods by which all product, selling, distribution, and other customer-related costs can be flowed back to the revenue source. In order to determine the effect on net system profitability, a number of factors will have to be considered. These will probably include (but not be limited to) the following:

- Order size profiles
- Customer size and individualities
- Special customer needs
- Special packaging or handling
- Product line differences
- Inventory turnovers
- Levels of customer services.

It should not be inferred that each and every customer must be individually analyzed. Generally, the needs for detail will be spelled out by your own characteristics. For example, if your product is in the grocery field, proper classification might require individual accounting for large chains, while all small independents might properly be lumped as a suitable segment. Different requirements for services might be a more meaningful grouping. Geographic differences may, in some cases, be of greater influence than the type of customer. Since you want to tailor *your* market strategies, you will have to tailor the inputs based on your own business. And a little A-B-C philosophy is always applicable here (i.e., spend more time looking at the significant dollars).

In the case of a $50 million company in the food business, an anal-



Salesmen were making hundreds of face-to-face calls where the potential margin couldn't possibly cover all the costs involved.

If your product is in the grocery field, proper classification might require individual accounting for large chains, while all independent stores might be lumped as a separate segment.

ysis showed that one major product which appeared to be only marginally profitable in total was actually capable of meeting profit objectives in certain markets under controlled conditions. Here was a classic case: a basically profitable "core" of business had been eroded by vigorous selling programs undertaken to achieve "growth." When the details were known, it was easy to tailor a marketing strategy that fit the cost and profit characteristics of this product and return it to acceptable status. By shrinking the volume back to its profitable base, net profit was actually increased by nearly $500,000.

When you are ready to begin your analysis, here are the key steps to take:

1. Select a test market that you feel is representative of a significant portion of your business.

2. Select an appropriate sample period.

3. Decide how you want to classify customers (i.e., how many individual customers should be analyzed and how others should be lumped together). If you have computer-based invoicing, it is usually not too difficult to analyze *each* customer in the test markets.

4. Measure the actual gross revenues derived from each transaction and develop appropriate profiles of the sample data.

5. Identify all costs (product standard costs, order processing, scheduling, warehousing, transportation, selling, technical service, and any other as appropriate) connected with the sample period sales volume.

6. Conduct a sensitivity analysis to determine the most critical cost elements, and, consequently, those which must be developed with the greatest accuracy.

7. Develop cost building blocks for each unit of customer-related activity. Synthesize costs (using industrial engineering data and techniques) where necessary to complete the development of total system costs from producing units to customers.

8. Evaluate the impact on the profitability of individual customers or logical business segments in each test market of changes in:

(a) Distribution methods
(b) Order size mix
(c) Service levels
(d) Selling methods
(e) Combinations.

9. Identify the general strategies (i.e., selective service levels, incentive pricing, distribution channels, etc.) that would motivate customers to accept changes in ordering policies or procedures or in distribution methods.

10. Prepare a detailed plan of approach to market testing and evaluation of the different strategies.

11. Implement the most promising changes and evaluate the results.

12. Develop a plan for expansion of the most successful strategies to other markets.

Will your company benefit?

Do you need customer profitability analysis? Ask yourself these questions:

• Is each organization profit center at or above the profit average for comparable business operations?

• Have past drives to improve (or maintain) share of market been successful although return on the increased volume was not quite what was expected?

• Is the business presently serving a substantial variety of customers and markets, using multiple distribution channels and employing "blanket" marketing strategies for all segments of the business?

• Have large customers been harder and harder to come by while "small" orders are making up a greater percentage of the business?

Chances are, if you have any of these problems, you are already struggling with the question of what to do about it. The solution is simple and direct—although not effortless. The time has come to analyze the ultimate profit center—the customer.