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Customer Profitability Analysis

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Customer Profitability Analysis

Over the past several years, companies have been extremely focused on their customers, trying to enhance customer service, paying more attention to customer needs and measuring customer satisfaction. Significant investments have been made and are now an inherent part of doing business.

One customer-related area that has been largely ignored or poorly executed is the understanding of customer cost and customer profitability. After having made numerous and sometimes large investments in delighting the customer, it is equally important to know the cost of serving your customers, which customers contribute the most to your bottom line, and those that do not, so that appropriate actions can be taken. For many companies, increased customer costs result from services such as:

- Smaller order quantities
- Customized and/or more frequent deliveries
- Producing and/or stocking a greater number of products.
- Requiring a company to hold inventory
- Increasing requirements for post-sales support

Dealing with these extra costs may require a company to charge for selected services, cutback on services provided, make those services more efficient, renegotiate contracts or even "fire the customer". Knowing your customer costs and profitability is crucial to making the right decisions about your customers.

Customer profitability is generally defined as the matching, assignment and/or allocation of company revenues and costs to its customers in order to understand relative profitability. Based on our experience, less than one third of all companies claim to know the profitability of their customers. And many of these firms have used arbitrary methods to calculate customer profitability that may cause them to make bad business decisions. In some cases, those customers thought to be the most profitable turn out to not even be profitable at all. For example, at one large manufacturer costs deemed to be customer related were allocated using a percentage of revenue dollars. For a high revenue customer, this method could allocate more costs to them than they truly consume. And conversely, a low sales volume customer may appear to be more profitable than they really are. If this manufacturer acted on this misinformation, it might deteriorate rather than improve its overall profitability.

Our Approach

We recommend the following approach to Customer Profitability Analysis utilizing activity based costing principles:

- ***Determination of Customer Process/Activity & Customer-specific Costs***

These costs include those such as sales, customer service and the warranty department that are incurred for all customers. It is critical to identify and understand these costs, as well as the major activities included and the key cost drivers. These costs can be benchmarked internally and externally and best practices can be identified and implemented. As a result, costs can not only be better assigned to customers but opportunities to reduce and/or redirect them can be identified so that the total cost to serve the customer can be decreased.

- ***Determination of Customer Profitability***

All revenue and costs need to be matched with customers so that profit can be determined. This information is critical to support decisions regarding strategic pricing, contract negotiations, rationalizing customers and/or the services provided to them, implementing new services and seeking new customers.

Determining Customer Process/Activity & Customer-specific Costs

We use the following steps to determine customer process/activity costs:

1. *Define Resource Pools*

Depending on the size of the company, the general ledger can contain hundreds or even thousands of accounts. Grouping similar accounts into pools of resources can simplify the process of mapping the resources to the activities. For instance, you will often group the salary accounts and benefit accounts into the same cost pool – even though they are often kept as separate accounts in the GL, they are handled the same way in this approach. There is no rule of thumb identifying the number of pools to define, you just want to make sure that every account listed on the general ledger can be accounted for in one of the resource pools. There is also no limit as to how many accounts can be included in a resource pool.

2. Map Chart of Accounts to Resource Pools

Once the resource pools have been defined, the next step is to map the general ledger accounts to the resource pools. The money associated with each account is also mapped to the resource pool. Therefore, if you mapped both a salary account with $1,000,000 in it and a benefit account with 300,000 in it, to the same cost

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pool, the cost pool would now have $1,300,000 in it. This step is complete when all of the accounts (and their associated dollar values) are mapped to the resource cost pools. Note that no dollar value has been either gained or lost; it has just been reclassified into one of the cost pools. The total dollar value of the cost pools will be equal to the total dollar value on the general ledger.

3. Identify / Define Activities

The intermediary between the resource pools and the customer costs are the activities. All of the activities that occur within an organization need to be identified. Typically, companies tend to identify approximately 100 – 125 activities encompassing everything that is done in the organization. Customer related activities are a subset of a company's activities. An important part of this process that is at times overlooked is the process of defining each of the activities. Having a documented dictionary defining the activities will eliminate any misunderstandings of the intent of the activity.

4. Identify Resource Drivers

This is one of the most difficult steps in the process. It involves the identification of how the resources are being consumed by the activities. The same resource driver can be used for multiple resource pools, but each resource pool must have a resource driver. An example of a resource driver used for a resource containing salary & benefit costs is "number of hours".

5. Map Resources to Activities

Mapping the resources to the activities means determining which resources the activities are consuming and how much they are consuming, i.e., assigning values to the resource drivers identified in the previous step. Therefore, if there are 2000 hours of activity in the period, and 1800 hours were spent performing activity A and 200 hours were spent performing activity B, then based on the example from the previous step, the resource containing salary & budget would be mapped to activity A with a value of 1800 hours and it would be mapped to activity B with a value of 200 hours.

In our experience, the most difficult hurdle to overcome in this step is that the data required may not be available. If this is the case in your organization, short term solutions include collecting sample data over a period of time and using it as representative data, or estimating the right values and using these numbers until the requireddata becomes available. The long-term solution should be to capture the data required.

6. Determine Activity Costs

Once the resource drivers have been identified and the resources have been mapped to the activities, the next step is to calculate the activity costs. Each resource that is mapped to an activity will result in an associated cost. The accumulation of those costs is the cost of performing that activity. The cost that each resource brings to an activity is based on the value of its resource driver to the particular activity as a percentage of the total drivers. For instance (illustrated in Figure 1), if the number of hours is the resource driver for a resource, and activity A consumes 1800 hours of the resource and activity B consumes 200 hours, then activity A would receive 90% (1800/2000) of the costs associated with the resource, and activity B would receive 10% (200/2000) of the costs associated with the resource.

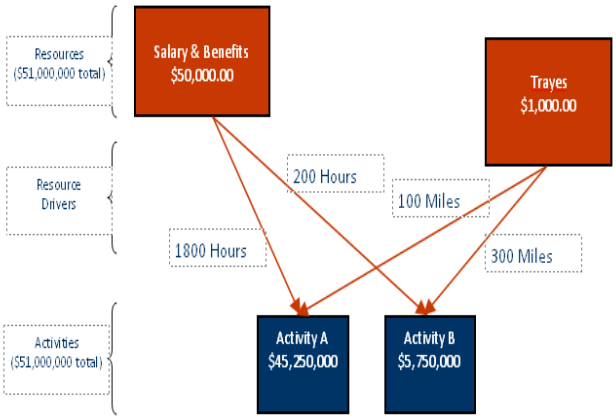

Figure 1: Determine Activity Costs

Once again, no dollars will be gained or lost; they are just being reclassified. The total cost of the activities will be the same as the total cost of the resources, which is the same as the total that appears on the general ledger.

We use the following steps to develop customer specific costs:

1. Identify / Define Customers

be able to determine the customer costs. While this may sound like an easy activity, it may require some decision making. For example, are different divisions of the same company that purchase your products or services considered to be the same customer or two different customers? The important thing is that all entities for which you want to determine customer costs are identified during this step.

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2. Define Activity Drivers

This step is just like the step in which you identified the resource drivers. The objective is to determine how to measure the way customers are consuming the activities, i.e., how to quantify what activities you are doing for your customers. Like resource drivers, there is no right or wrong activity driver to select. Some examples of an activity driver for the activity "Provide Customer Support over the Telephone" could either be "number of calls received from the customer", or the "number of minutes spent supporting the customer".

3. Map Activities to Customers

In the previous step, activity drivers were explained as a means of quantifying what activities you are doing for your customers. In this step, you need to identify what customers you perform each activity for, and how much of it you are doing.

4. Determine Customer Costs

Customer costs are calculated the same way you calculated the activity costs. Each activity that is mapped to a customer brings along an associated activity cost. The accumulation of those activity costs determines the customer cost. As with resource costs, the activity cost mapped to a customer is based upon the value of that driver as a percentage of the total drivers. For example, consider the mapping of the activity "Provide Customer Support over the Telephone," which has a cost of $5,000,000 to customer A and customer B. Customer A receives 1500 minutes of support, while customer B receives 3500 minutes of support during the same period. In this example, 30% (1500/5000) of the $5,000,000 will go to customer A, and 70% (3500/5000) of the $5,000,000 will go to customer B. This means that you spent $1,500,000 in this period to provide customer support over the telephone to customer A.

The cost of each customer is determined by the sum of all of the activity costs that go to that customer.

The aggregate cost of all your customers will be equal to the same cost of all your activities, which is the same as the cost of all of the resource pools and the total amount in the general ledger. As stated earlier, this is because during this entire process, no costs are gained or lost – they are just reclassified.

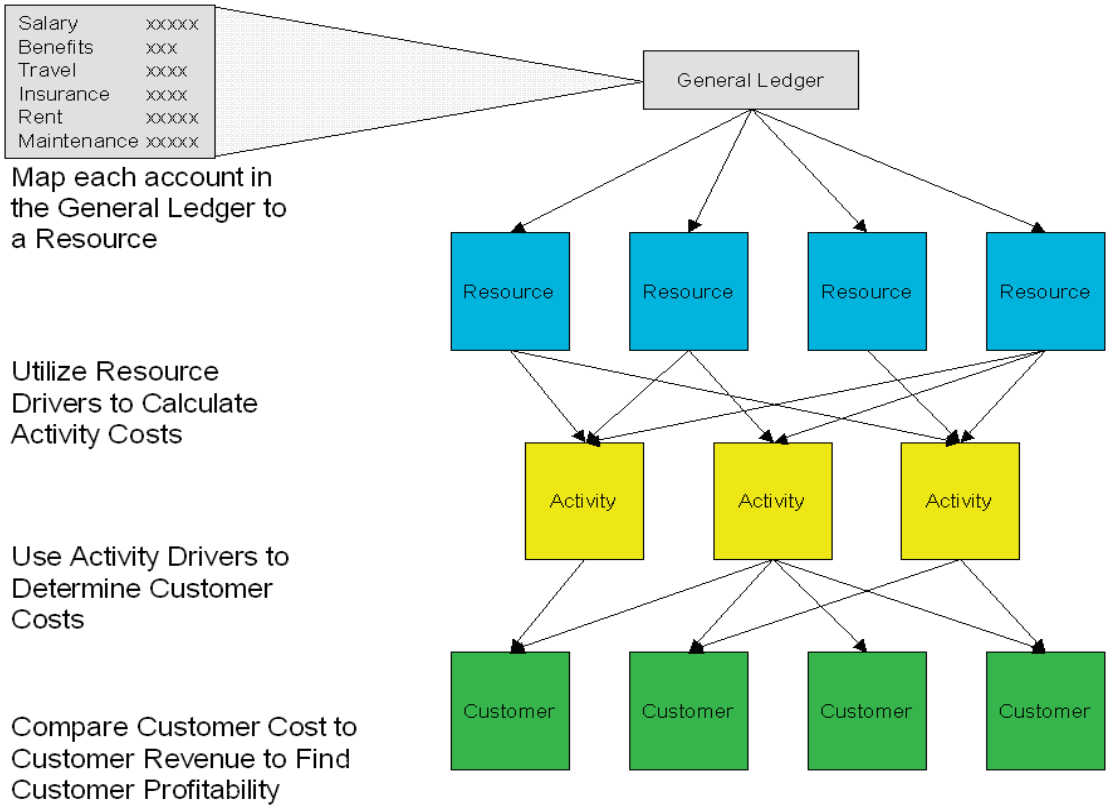

Figure 5: Health and Wellness Matrix

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Determining Customer Profitability

The following major categories should be included in the determination of customer profitability:

Customer Revenue

Revenue is generally the most straightforward category to determine. Companies usually have information that captures sales/revenue associated with specific customers. Other information needed may include customer discounts, rebates and other deductions.

Customer Product Cost

Product cost is typically the largest cost category and is usually calculated or estimated by every company. Sometimes companies calculate product costs for analytical purposes which differ from those used by accountants to value inventory. We generally find that many companies have a product costing system in which there is a varying degree of management confidence. Our approach assumes that product costs are accepted by management and are appropriately calculated for use in determining customer profitability. If not, the effort to determine customer profitability must be expanded to include a potential revision to product costing methods. This review is necessary because there may be some cost types that have been included in product costs that are related more to the customer than to a product. These costs may include, for example, engineering or design costs, special manufacturing equipment and practices, or even invoicing and collection. If significant, some or all of these costs may have to be removed from product cost and, instead, be directed or assigned on a customer basis.

Customer-specific Costs

As already discussed, customer-specific costs are those costs that are driven primarily by the needs or demands of a particular customer. Besides the costs identified above which may have been incorrectly classified as product costs, they include many of the costs which are usually referred to as Selling, General & Administrative costs. However, they are viewed from the customer's perspective and the way in which they add value to the customer. These would include sales, marketing, distribution, advertising, legal and executive expenses.

Asset Opportunity Costs

Asset opportunity costs are those costs that can be assigned to customers based on the assets of the company that a particular customer consumes. They could include working capital such as inventory and accounts receivable as well as fixed assets such as machinery & equipment. For example, certain customers may demand inventory to be available immediately, requiring the seller to keep stock on-hand. Or, another customer may be very slow in paying its outstanding invoices, resulting in high accounts receivable balances. The opportunity cost is calculated by multiplying a company's cost of capital (or some appropriate interest rate) times the average asset value utilized. This cost for capital amount reduces overall customer profitability.

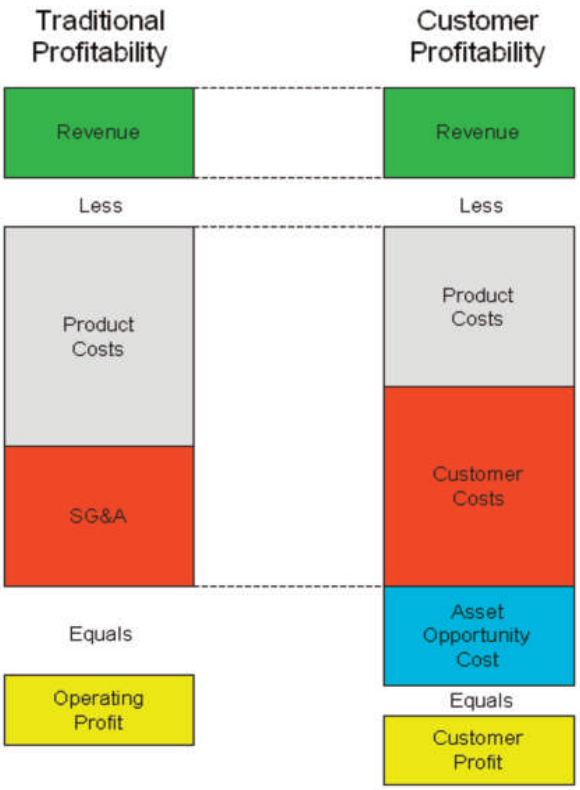

Figure 3: Customer Profitability Framework

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Conclusion

Knowing customer cost and customer profitability is critical for a company today. Knowing your total costs for particular processes and activities allows you to focus on reducing and controlling them. Knowing costs for a specific customer allows you to reduce, change or charge for activities/services provided to them.

The determination of customer costs and profitability should be performed using activity based costing techniques. Although it requires the availability of customer-related data, the calculation is straightforward. Customer cost and profitability information is so important to a company that if the right data is not available or does not exist, it must be made available or created.

Although many companies do not have customer cost and profitability systems, a growing number are beginning to develop them and it is imperative that you develop the information before your competitors do.

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