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Creating More Profits by Managing Your Customers
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The age-old principle of "The Customer is always right" has moved aside and understanding your "Customer Profitability" has taken its place. Unfortunately, most of our current accounting system does not have the capacity to show you your profits by customer, and even less can tell you which customers are costing you too much to keep.

Understanding the profits of a Small to Mid-Sized Business (SMB) or a segment of the SMB has long been an output of most accounting systems. Most accounting systems typically provide geographical and product line information on revenues, costs of goods sold, operating expenses and other related topics. The area that most Cost Accounting Systems (CAS) fails to address is **Profitability by Customer**. With the level of information generated through the application of ABC concepts and techniques, forward looking organizations are identifying the profitability of individual customers.

Over the past 23 years, the professionals at Balog + Tamburri, CPA's has maintained By-Customer Profitability statistics. Our studies show that about 80% of a company's current customer base generates about 130% of the current level of profitability. This means that the remaining 20% cost more to maintain and service than the revenues they generate. Being able to identify which customers are truly profit generators and which are not is a powerful profit-development management decision support tool.

This whitepaper outlines some of the techniques we include in our client's Cost Information Systems (CIS) to drive strategic decisions relating to:

- Customer Retention
- Product Pricing
- Pricing of Maintenance Contracts
- Return on Specific levels of customer service

The difference between a CAS and a CIS is significant to the SMB owner.

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Customer Profitability Analysis

Some customers require more attention than others. Every sales professional can identify the high and low maintenance customers. The cost of customer support and retention can be driven by:

- Customization
- Packaging Requirements
- Engineering Change Orders
- Shipping and Handling restrictions
- Inventory stocking levels.

While the drive for excellence in customer service is always a paramount focus of every SMB, it is important to understand the costs incurred to service each customer as compared to the revenues generated by that customer.
In the supply stream management process, understanding the **Total Cost of Acquisition** is a normal output of the CIS. Customer profitability analysis simply takes this concept, and applies it to the internal customer support activities of the SMB.

For example, Ted sells their "Safe-Tite" Wheel Locks to two customers; Go Fast Auto Parts and Safe Driver Auto Parts. The wheel locks are the identical. However the demands of the customer are different.

- Go Fast requires the parts be packaged in purple and neon packaging. Safe Driver is satisfied with the standard clear packaging. The cost difference for the packaging materials is less than .5%.
- Safe Driver Auto Parts accepts Ted's standard packaging.

Should Ted charge Go Fast a higher price for the wheel locks?

From a typical cost accounting perspective, they answer would be no. Product costs are the same, and packaging costs are considered as manufacturing overhead, with the costs allocated to all products on a Direct Labor Hour (DLH) basis. . Assuming each pays their own shipping, the typical product costs are the same.

However the major hidden costs of servicing Go Fast, that are in excess of the normal packaging include:

- The purchasing department finding a supplier for the Purple and Neon packaging
- Additional items in the materials inventory which drive warehouse space, I/T support, cycle counts, etc
- Additional costs of supply stream management
- Additional accounts payable costs
- Additional time for packaging set-up and take down.

Since corporate overhead is allocated to all products on a DLH basis as well, Ted winds up showing a greater that true cost for Safe Driver and a lower than true cost for Go Fast.

The customer profitability analysis can provide management with a very new perspective in the hunt for additional revenues from the existing customer base, and in pricing products for new customers in the future.

Developing the Customer Profitability Analysis Model

The Customer Profitability Model consists of the following components:

- Recognition of revenues by customer
- Recognition of production costs by customer
- Recognition of the cost of activities triggered by the following drivers, by customer:
    - Unique packaging and other minor production customization
    - Unique billing / invoicing arrangements
    - Unique production runs
    - Warehousing of contingency stock
    - Unique merchandising requirements
- Development of a customer-driven P&L statement.

Using Activity-Based Cost Accounting (ABC) to identify the costs of products delivered by support groups, such as I/T, accounting, purchasing, and others, is the key element of the customer profitability analysis. If the physical and financial structures of the support processes do not change significantly, the cost of each unique product produced by support groups need only be analyzed annually or semi-annually to ensure reasonableness.

For example:

Go Fast's unique packaging requires the following to occur that would not occur if they accepted the normal packaging:

- Twelve additional
    - purchase requisitions @ $12.00 each = $144.00
    - purchase orders @ $15.00 each = $180.00
    - material shipments received @ $30 each = $360
    - invoices processed @ $35.00 each = $420.00
    - checks issued @ $30.00 each = $360
- One additional approved supplier for 365 days @ $.55/day = $200.75
- One additional supplier on the authorized check issuance register for 365 days @ $.55/day = $200.75
- One additional SKU maintained on the perpetual inventory listing @.$.55/day = $200.75
- One additional item to cycle count each year at @ $55 per each = $55.00
- One additional RFP to be issued and reviewed each year @ $250 per RFP. = $250.00

The carrying cost of the inventory is not a cost factor, since Ted would have to carry additional inventory of the standard packaging for Go Fast.

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This means that the total additional cost for Ted to provide Go Fast with its unique packaging is $2,371.25. If Ted's margin is $10.00 per unit sold to Go Fast, Ted would have to sell 237 additional units to break even for the additional costs incurred to maintain Go Fast as a customer.

By understanding the hidden costs driven by customer's unique requirements, the company can make a more informed decision. Which leads us back to the question, "Are you ready to fire your marginal customers?

You should be.

In addition to the obvious costs relating to the packaging of the Go Fast wheel locks, marginal customers are costing you more than you realize. It is easy for a struggling SMB owner to rationalize that by accepting lower margins on some customers and making higher margins on others is OK, especially if your sales are down. However, this only works if you and your business has unlimited resources and you have unlimited time. It is more than likely that your cash reserves, credit line, production capacity, and your company's ability to carry Inventory and Accounts Receivable have limits. Finally, you only have 24 hours in each day. Spending one of those hours dealing with a poor, demanding, slow-pay customer prevents you from effectively serving the good ones.

The following is a sampling of some of the customer traits to look for in identifying "Hit List" customers and some ways to either turn them into Good Customers, or send them packing to your competition. Let the competition go out of business.

The 90-Day Customers
The Situation: You know the type. Their story is "I am really having a tough time now. I will pay you next week." This requires a series of phone calls and multiple invoices. In the meanwhile, you are paying interest on your line of credit, and you do not have the cash to pay your employees and your bills. They always have a good story of doom and gloom, and they apologize for tardiness and promise that the "The check is in the mail." On the other hand, they blame YOU for faulty merchandise, poor service provided, late shipments, etc.

The Solution: Develop and communicate clear credit policies. Charge them interest on open accounts over 30 days. Put them on a COD status. Require payment of all open invoices before additional shipments are made. Don't be fooled and re-extend terms after only one or two prompt payments. Wait a year or six months before revisiting the credit status of the customer.

The "I Can't Decide" Customer
The Situation: You have a customer that is constantly altering or continually expanding their needs, but won't tolerate a change in your price. These are the customers who shop at the "Price-Club" store, and expect "Needless Markup" level service. Typically, they see needs as basic because they haven't totally analyzed and communicated their real requirements. As you

begin to provide the service, or build product, they redefine their requirements and don't want to pay more than the original price.

The Solution: While these may not necessarily be bad customers but they don't understand the impact the change has on YOUR business. For existing contracts, before firing them, educate them. Let them know the impact of the requested change and tell them that there will be an additional charge. Then, if they balk**, "Down the Road!"**

In the future structure contracts that define project scopes and service levels, and specify scenarios that may involve additional fees. Your goal is to make sure that both your company and your customers commit appropriate resources prior to the start of a new project. Be wary of over-eager customers who want to start now and either don't want to spend a little money on a preliminary needs-assessment analysis, or don't have time. These always come back to bite you. Finally, cast a dubious eye on the new customer that has a "Sure Thing" process, or hoping to quickly capture a sure-to-skyrocket market or revitalize a failing business. Marginal business ventures can rapidly consume your cash reserves. Choose wisely.

The "Discount Coupon" or Incentive Customer
The Situation: You distributed a coupon to advertise and attract new business. The offer was a "Limited Time Only" or similar offer. Or you agreed to accept a lower fee for this contract only to help your client. Now, these customers won't accept the higher price and demand the lower cost indefinitely.

The Solution: First determine the pricing and terms you'll accept to keep the customer. Speak with the customer and specify the standard prices and when the discount period ended. Explain why you need to bill at the standard rate. Don't waver. Be firm. If you're confident that you've already made sufficient concessions to please a demanding customer, then it's time to refuse additional business at any price.

If you would like a Free Consultation to assess the profitability of your products and customers, please call:

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