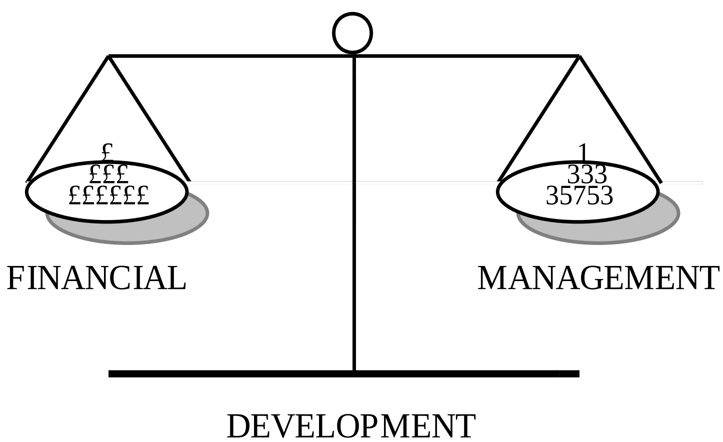
FINANCIAL MANAGEMENT DEVELOPMENT

Decision Making

Customer Management

NO 322

CUSTOMER PROFITABILITY



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

FROM

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

CUSTOMER PROFITABILITY

OVERVIEW

Customer Profitability is primarily a review technique that assigns income and costs to customer groupings rather than product groupings. It is not a new accounting system nor is it a magic formula to help sales price negotiations. However, used properly it can assist managers assess their customer portfolio to set priorities and aid both tactical and strategic decision making. As a technique it is similar to product costing but it has the benefit of being customer focused rather than production led. It also owes much to the Activity Based Costing approach since in many areas it will be necessary to apportion costs on some reasonable basis. The nearer the basis used to the true "Cost Driver" the better the quality of the resulting analysis.

Using a single product, single customer as a base case it is possible to show how the various indirect costs in an organisation grow. Through sensible analysis, allocation methods can be devised to identify the causes of costs and minimise the costs as a result. It is stressed that the value of the exercise is in the use of the information it produces. The production of the information and its levels of accuracy are by products of the process. The continuing quest for further information and greater accuracy should be avoided. The Pareto principle applies to management information as well as to products and customers.

HOW INDIRECT COSTS ARE GENERATED

A one product, one customer company is a simple concept - so simple that it frequently exists in sole trader form as a contract of employment. However, as organisations grow they tend to expand until they provide many products to many customers. In some cases they provide too many products to too many customers. They may be aware that some products and customers are less profitable than others - but they may not have the information available to decide which. The reason is that centralised functions will have developed to meet a variety of needs and in order to avoid unnecessary cross charging their services are not explicitly paid for by the customer.

All customer costing does is to remind managers that customers, and groups of customers, have to be reviewed to ensure they are "profitable". By definition some customers and products will be less profitable than others. The Pareto principle that 80% by volume will provide only 20% by value suggests that there is a cut off point below which some activities are uneconomic.

THE USES OF COST INFORMATION

Chronologically cost information can be used:

1. To decide on whether to initiate a new project or product, or accept an order.
2. To decide on how to proceed when faced with alternative ways of fulfilling the need.
3. To revise the terms - prices up, costs down, or the structure of the deal.
4. To promote or expand a line of business.
5. To stop a line of business.

Each of the above is as applicable to customer groups as it is to product groups. Large multi-product organisations have product de-listing committees in order to ensure that the product base is not made over complex by the constant addition of new lines and variations on a theme as customer needs vary.

AN 8 STAGE APPROACH TO CUSTOMER COSTING

It is stressed that this is a strategic planning exercise. It should not be used as a basis for the mainstream accounting system unless the allocation methods are straightforward and constant. Most Indirect Costs have to be allocated on a relatively arbitrary basis and that implies restriction of the allocations to management accounting uses rather than financial accounting. In many instances this avoids possible distortion of the data by manipulation of the cost drivers rather than positive action.

1. IDENTIFY ALL INCOME AND COSTS FOR THE ORGANISATION

Whilst a detailed Profit and Loss account will be a useful start point, it makes sense to define the organisation (particularly where there are separate divisions servicing the same customer) and to set sensible limits on the costs to be considered. Most companies use operating profit but there is an argument for including interest and in some cases tax.

2. IDENTIFY THE CUSTOMER GROUPS

This may be large customers, industry or geographical segments. They should be identifiable and should have similar characteristics. They should include all customers - even if no action can be taken e.g. fellow members of a group of companies - since exclusion may distort the total data.

3. IDENTIFY ALL INCOME SOURCES AND COST HEADINGS DIRECTLY IDENTIFIED WITH THE CUSTOMER GROUP

Again it is important that all major items are identified, but it is not vital to achieve 100% accuracy. It is unlikely that minor discrepancies will affect the overall decisions. The key word is "direct". If the main cause of the cost is that group then it should be classified direct. If not then leave it to be allocated as an indirect on an appropriate basis under step 4 below.

Note that where appropriate the income should be at normal sales price, with special terms being treated as a cost. This allows proper comparison. Similarly interest income or expense should be reviewed to analyse it on the basis of capital invested fixed assets and working capital. Some customers who pay in advance, or provide their own assets may be subsidising those who require considerable capital investment.

4. **IDENTIFY THE MAJOR INDIRECT COSTS AND CONSIDER APPROPRIATE COST DRIVERS**

Allocate all costs on the most appropriate basis. Examples include personnel costs on headcount, buildings costs on floorspace, communications costs on numbers of handsets or switchboards etc. In some cases consideration should be given to the cause of the cost and approximate allocations made e.g. sales force time should be on the distance travelled to the customer and not necessarily on the value of the order taken.

5. **ESTABLISH THOSE COSTS WHICH ARE NOT CUSTOMER RELATED. REDUCE THEM OR SAFEGUARD THEM AS AN INVESTMENT IN THE FUTURE**

Some costs are not directly related to the customers.

These can include general advertising (i.e. not to specific groups), parent company charges, Research Departments etc. Provided these are valuable to the organisation i.e. a conscious decision has been made to keep them then they should be grouped together and allocated on some reasonable basis e.g. Sales Value or Volume.

6. **CALCULATE THE "TRUE" CONTRIBUTION FROM EACH GROUP**

By definition the analysis will cross cast and should show contribution to net profit from each area.

7. **REVIEW THE RESULTS AND CONSIDER IF ANY AREAS WARRANT FURTHER INVESTIGATION**

It is normal for the results to be most useful at the two extremes. Large customers who are either squeezing their suppliers, or conversely are providing a dangerously high percentage of total profit. Small customers who are being serviced at uneconomic costs. It is vital that further work concentrates on specific questions and includes a limit on the level of detail required.

8. **TAKE APPROPRIATE ACTION**

The earlier steps are useless unless action is taken. Action includes a decision to do nothing, change procedures, review prices etc. It should be taken in the light of all factors - not just financial.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

