ARE ALL OF YOUR CUSTOMERS PROFITABLE TO YOU?

Using activity-based cost management to measure customers. BY GARY COKINS, CPIM

It is no longer sufficient for an organization alone to be lean, agile, and efficient. Its entire supply chain must also perform like it does. Any trading partners that require high maintenance erode profit margins. Most organizations have focused their purchasing department to rationalize supplier choice based on the lowest cost with acceptable service. But on the other end, who are the troublesome customers, and how much do they drag down margins?

Any customer, from the small one buying low-margin products to the largest buying the highest-margin products, can be a drag on profitability. Once these less profitable customers are known, management can determine how to act, either by trying to turn unprofitable customers into profitable ones, or by "firing" the customer.

All customers are not created equal

IF TWO CUSTOMERS PURCHASE the exact same mix of products and services at the exact same prices during the exact same time period, would they be equally profitable? Of course not. Some customers place standard orders with no fuss, while others demand nonstandard everything, such as special delivery requirements. Some customers just buy your product or service line, and you hardly ever hear from them; while others you always hear from—and it is usually to change their delivery requirements, inquire about and expedite their order, or to return or exchange their goods. Some customers require more post-sale services than others do. In some cases, just the location of the customer makes the difference.

The question is: Is the bothersome or geographically distant customer worth it? Put another way, if a company adds up the costs of time, effort, interruptions, and disruptions and adds it to the basic cost of product and service, does the company make a profit?

The pursuit of truth about profits

ANSWERING THE QUESTIONS POSED above will in turn help a company to answer more direct questions about its customers, such as:

- Do we push for volume or for margin with a specific customer?
- Are there ways to improve profitability by altering the way we package, sell, deliver, or generally service a customer?
- Does the customer's sales volume justify the discounts, rebates, or promotion structure we provide that customer?
- Can we realize the benefits from our

At-a-glance

- Customers buying the exact same product mix at the same time will have different profitability based in part on the service levels they demand.
- Activity-based costing is a technique that accounts for the various service levels as well as all other costs associated with a customer.
- This method can then be used to classify the profitability of customers so management can take action to either raise profitability of some customers, ensure the most profitable customers are kept, and fire those that are not profitable.

changing strategies by influencing our customers to alter their behavior to buy differently (and more profitably) from us?

To be competitive, a company must know its sources of profit and understand its cost structure. In financial accounting terms, expenses are the costs associated with selling, advertising, marketing, production, logistics, warehousing, and distribution. For external reporting, the accountants comply with rules and immediately charge these expenses to the month in which they occur. What few accountants do, however, is trace the expenses as costs caused by their customers in proportion to how they place demands on work.

Determining true profitability requires specialized accounting techniques. Activity-based cost management (ABC/M) is a refined form of absorption costing that can accurately trace the consumption of an organization's resource expenses based on the varying demands different customers place on the company. Determining the "costs-to-serve" for various customers is logical with ABC/M and will show which customers erode profit margins based on their demands on work, their sales and distribution channels, and their service requirements.

ABC/M traces segments and reassigns costs based on the cause-and-effect demands triggered by customers and their orders. ABC/M refers to these triggers as "activity drivers." An example would be the number and type of orders processed (e.g., standard orders, specials, adjusted, international, etc.). When the cost of processing a customer's orders is subtracted from the

CRM INTEGRATION

According to Dale Hagemeyer, senior research analyst, CRM Group, at Gartner Research, many companies have been trying to measure customer profitability for years, and many do a good job. The problem is the methods companies often employ.

He recently consulted with a large, diverse manufacturer of consumer goods. When the CEO of this firm met with a major chain retailer, he couldn't tell the customer just how much business the two companies did with each other. "It's the consolidated view problem," notes Hagemeyer. "Each of my divisions probably knows what it does with a particular customer, but getting all that information together and aggregated means making several phone calls and waiting for responses."

Whether it's a consolidated view problem that spans multiple divisions or simply multiple databases within a single plant, someone has to collect the information and crunch the numbers. That's where an advanced customer relationship management (CRM) system comes in. In fact, Hagemeyer says, calling CRM a system on its own is not particularly accurate. "I say CRM module, specifically because for it to be more than just a contact management program, it needs to integrate with other systems from the organization." And therein, he says, lies the biggest problem with the CRM systems available today. "Most of the systems out there don't focus on connecting the back-office applications to the front-office applications."

Hagemeyer says the ERP companies with CRM modules tie in to the back end nicely but have limited functionality. On the contrary, CRM-only companies are functionally rich but tie in to the back end only in rudimentary ways if at all. In both cases, Hagemeyer reports, companies are coming around, with the ERP firms slightly ahead.

One such firm is PeopleSoft, who only recently released a functionally-rich CRM module, which can be deployed as part of its ERP offering or integrated with other back-end systems.

"The nirvana—the Holy Grail—is to be able to provide an end-to-end solution," says Robb Eklund, vice president for CRM marketing at PeopleSoft. "It's not as simple as it may seem, you need a deep understanding of the inherent data to support transactions."

Eklund continues, "We believe that companies are investing in all this technology infrastructure to support operational data. In the end a solution that gives visibility in a meaningful way to that data regardless of where it resides is what PeopleSoft has done."

On the other side of the fence, a CRM firm that places a high emphasis on integrating in the back end is CAS America, a provider of CRM systems to the consumer goods industry.

"If you're going to act in [the consumer goods] industry," says CAS Senior V.P. of Sales Jeff Cronon, "you cannot act as an island and be your own repository of information. You must have a bi-directional interface with the back office so you have all the promotions, scheduling, forecasting, and all other data that you need."

Cronon notes that at an implementation with Nabisco, the CRM has more than 30 touchpoints where it collects data from other systems.

"We see ourselves as a doorway of customer information," Cronon says. "We take information, including profitability, and push it out in an actionable form to the people who interact directly with customers, whether that's sales, internal customer service, or production managers."

CAS has achieved SAP certification, meaning the data pathways behind the scenes as well as the look and feel of the program are easily integrated into MySAP. In addition, Cronon notes, CAS has been integrated with other ERP and legacy systems.

—Scott Briscoe

sales for those orders, a company can know historically whether it actually made or lost money. A company will also know prospectively whether or not an accepted price quote for a future customer order will be profitable.

Some employees intuitively suspect the truth—that there are losers—but these employees will likely presume that their companies would never want to "drop" those customers. Also, they perceive that those customers still provide sales volume that somehow "covers the overhead." But maybe all the product costs, base service costs, and unrecognized extra costs alone are not fully recovered by the sales prices. Some employees believe that on average there is very little that distinguishes any differences between customers, so they basically view customers as clones for each other. In other situations, some employees are evaluated or motivated with commissions that are based on sales volumes, so they don't place as much importance on costs and profits—only on sales volume.

The issue here is not only determining the profit contribution of customers, including accurate costs for the products they buy, but also understanding the elements of customer-specific work that comprise the entire costs to serve each of them. It is imperative that accountants have a rational system of assigning so-called nontraceable costs to their sources of origin—whether those sources are suppliers, products, or customers.

"Firing" the customer

ALL FASTENERS, A DISTRIBUTOR of fasteners in Racine, Wisconsin, applied ABC/M to analyze their thousands of customers by clustering them into common categories based on how they place demands on his work force and equipment. Executives combined these costs with composite profit margins of the mix of items purchased, which come from direct costs and prices that are easy to measure. The results were shocking. Although the company could have enjoyed a high level of unrealized profits, the unprofitable customers detracted from the profit. The major reason for the surprise is no one had ever seen the profit margins displayed by reporting a profit and loss statement for each customer.

Some employees intuitively speculate that they have a big winners and big losers profit portfolio mix for their products and customers—but they can never prove it. With ABC/M they can. All Fasteners took action. They "fired" about 500 of their unprofitable customers—but this wasn't done in a vacuum. They needed to replace these customers with ones that fit the profiles of their existing profitable customer base. A net loss of 500 unprofitable customers may be a good profit decision, but it would leave loads of excess capacity in production.

An additional critical reason for knowing the profit contribution of each customer is to protect the most profitable customers from competitors. Often only a few customers account for a significant portion of the profits. The risk of losing them to competitor attacks is enormous.

Beneath the iceberg: unrealized profits

WHEN COMPANIES TAKE THE time to define and measure their in-house work activities and directly associate them to the bigger and smaller consumers of their work, the obvious occurs. In addition to the products and base services provided to customers, there are big users, small users, and middle-of-the-road users of other portions of a company's workload. But since pricing is usually determined (and quoted) based on average standards, those customer-driven imbalances are rarely reflected in the pricing. In most companies, high-maintenance and low-maintenance customers are equally priced and reported as equally profitable, though this is far from reality.

When the inequities are replaced with true consumption measures of the costs-to-serve customers, the companies who have performed an ABC/M analysis have realized what All Fasteners discovered—they make a lot of profit on the winners but simultaneously give back too much unrealized profit on the losers. And both the profits and losses are usually big numbers. The company only banks the net difference.

Some organizations are stymied because they are experiencing an increase in sales volume but decreasing profit margins—and the financial controller's department cannot explain why. An ABC/M analysis could reveal shifting sales in the customer mix as the reason. Selling more to an unprofitable customer will likely erode profits, not increase them. Ironically, most sales force commissions focus on sales and ignore profits. In addition, the increasingly popular customer relationship management (CRM) software systems rarely report customer profit levels (see "CRM Integration" on page 44).

Technology aids organizations to understand the source of their profits. Profits can be viewed by any combination of product, service, channel, or customer. ABC/M users refer to this data mining and navigating as multi-dimensional reporting, and they use online analytical processing (OLAP) software tools for viewing the output produced by the ABC/M calculation engine. This is powerful information. The sum of all of the customer profit and loss statements for this type of report will exactly equal the entire business' enterprise-wide profit (or loss). That is, it reconciles with the company's official books—the bottom line.

Future competitive differentiation will be based on the rate at which organizations learn, not just the amount they learn. The organization that understand and masters ABC/M is on its way to understanding its customer profitability. Finally, having the visibility to all of this cost and margin data is really just the beginning. People must act and make decisions with the data. ◆

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