Customer Profitability: The Approach Counts

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By Mark Pickering

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This article looks at alternative approaches to calculating customer profitability. It recommends a customer-focused approach that takes into account the specific resources utilised to service each customer segment. It using customer profitability to make strategic and operational decisions it is vital that only costs relevant to those decisions are utilised.

Managers across most industries are increasingly realising the need for customer profitability information to run their businesses. This customer profitability information is required to focus expensive marketing, customer acquisition and customer retention programs on profitable customers. Constantly increasing competition means companies can no longer afford to subsidise non-profitable customers. Information is required to identify non-profitable customers and design actions to move them into profitability.

Meeting this demand for customer profitability information often ends up the responsibility of the finance department. Traditional costing systems are of limited use in providing the required information. An alternative approach is therefore required.

Varying levels of success have been realised by those that have ventured down the customer profitability road. The response of management to initial customer profitability information is often extremely negative. Initial attempts often provide incomplete costs, do not take into account the business realities of servicing customers and do not provide the flexibility to meet management’s varied decision requirements. In worst cases misleading customer profitability information has been used to make damaging decisions.

“Information is required to identify non-profitable customers and design actions to move them into profitability.”
Customer Profitability Approach

These problems are often due to flaws in the customer profitability approach used. Using a valid approach to customer profitability can provide extremely useful information for management decision-making.

This article looks at three of the more common approaches to determining customer profitability, along with the benefits and issues associated with each. It concludes that a customer-focused activity based costing (ABC) is an appropriate approach and that flexibility of costs is required to support different decisions.

ALTERNATIVE APPROACHES TO CUSTOMER COSTING

Most traditional costing systems don’t provide much support to customer costing. These systems are usually focussed on the costing of products or services and rarely address customer profitability. In manufacturing, many of the traditional systems allocate only manufacturing costs to products and ignore the costs which are predominantly customer driven, such as sales, customer service and delivery costs. Implementing customer profitability therefore requires an alternative approach.

There are three major approaches being commonly applied to customer profitability. These approaches are:
1. Gross margin allocation to customers
2. Full product costing to customers
3. Customer focussed activity based costing (ABC)

This section describes each of these approaches and indicates some of the benefits and issues of each (Table 1 summarises these) as well as stressing the importance of using relevant costs in decision analysis.

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<tr>
<th>Approach</th>
<th>Benefits</th>
<th>Issues</th>
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| 1. Gross Margin Allocated to Customers        | • Relatively quick and easy to implement with existing systems and information  
• Indicates customers with negative/low gross margins   | • Ignores a large portion of customer costs which are customer related, ie all below gross margin costs  
• Can result in skewed results eg all customers are profitable, when the company loses money |
| 2. Fully Costed Product Cost Allocated to Customer | • All relevant costs are allocated into the customer base  
• Can use existing ABC product profitability information efficiently  
• Profitability reflects the average full profitability of products/services supplied to the various customers/customer segments | • Treats all costs as product driven, when many costs are related to customers  
• Can cause distortions as it does not recognise that:  
  • different levels of service are provided to different customer segments  
  • many costs of servicing customers are fixed and therefore profitability is also volume driven  
  • Significant averaging with the implicit assumption that the cost of providing a product or service is the same for each customer/segment. This is seldom valid  
  • Significant effort to implement from scratch  
  • Difficult to identify costs which are variable to customers |
| 3. Customer-focused Activity Based Costing    | • Allocates customer related activity costs to customers serviced through those activities  
• Removes customer averaging involved in using product profitability  
• Reflects reasonably accurately the costs of servicing different customers/segments  
• Can leverage significantly on existing product costing ABC work  
• Has flexibility to meet different decision needs | • Significant effort to implement from zero base  
• Needs to be carefully planned to attain required flexibility |

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Customer Profitability Approach

1. Gross Margin Allocated To Customers.

This approach allocates gross margin to customers based on the volume of products/services purchased and the gross margin of those products/services. The approach is shown in Figure 1.

This approach is relatively easy to implement using existing information, however it has a number of limitations. While it does indicate the gross margin profitability of products/services sold to specific customer segments, it does not consider the specific costs of servicing the customers. Many of the costs of servicing customers are below the gross margin line and not included in this analysis. In many companies costs below the gross margin, and therefore excluded from customer profitability analysis, are more than 50% of total costs.

“This approach is relatively easy to implement using existing information, however it has a number of limitations.”

One manufacturing company using this approach identified all customer segments as being extremely profitable. This information was of limited use to a company that was losing many millions of dollars a year. This limitation is highlighted in Figure 1 which shows a company loss of $20,000 while customers are all profitable, for a total profit of $50,000. This analysis does not enable management to action the overall profitability problem.

Some companies have modified this approach by allocating the rest of their costs to customers using the same proportions as the gross margin. While this allocates all costs to customers it makes the assumption that the cost of servicing customers is related to the gross margin. This is seldom true and results in misleading or mistrusted profitability numbers.

2. Full Product Costing To Customers

This approach involves allocating all costs to products/services and then to customers based on sales of those products/services (see Figure 2).

This approach provides substantial improvement to the gross margin approach. It allocates costs from below the gross margin as well as those above and ensures that customers buying high cost products/services are allocated the costs of those products.

![Figure 2. Full Product Costing To Customers](image)

This approach is common where a company has implemented ABC focussing on product costing/profitability and is using those results to determine customer profitability.

“It does not take into account one of the main issues to be addressed by customer profitability analysis, it actually costs more to service some customers.”

The downside of this approach is that it averages the cost of selling, delivering and administering products across all customers buying that product. It does not take into account one of the main issues to be addressed by customer profitability analysis, it actually costs more to service some customers.

For example, many large customers are using their purchasing power to push many of their costs back onto suppliers. Additional activities, such as frequent just in time deliveries, stock holding costs, stacking of customer shelves and joint promotion costs are not identified to specific customer groups incurring these costs in a product costing to customers approach.

The finance team of a North American telecommunications company was sent back to the drawing board by the executive group when it was identified that the customer profitability approach used did not take into account the additional costs associated with the excessive customer churn and address changes generated by one customer group.

3. Customer Focussed Activity Based Costing

This approach recognises that many of an organisation’s activities, and therefore costs, are related to servicing customers and are not product driven. The approach, shown in Figure 3, enables companies to identify the true profitability of customers based on the specific resources used to service each customer group.
Costs are allocated to the activities performed in the organisation. Customer related activities, such as sales customer service and deliveries, are then allocated to customers supported by these activities based on cost drivers. For example - the costs of the sales force may be allocated to customers based on the number of sales visits.

Product related activities, such as engineering, manufacturing and product specific marketing, are allocated to the products/services provided and then allocated to customers based on the level of sales of each product/service.

“The approach enables companies to identify the true profitability of customers based on the specific resources used to service each customer group.”

Organisation sustaining (overhead) costs, ie those that do not relate to either products or customers - for example organisation management costs, can be allocated to customers through an overhead allocation to products or customers. It is important to note, however, that only relevant costs should be included in decision analysis (see next section).

A food distribution company used this approach to identify that 40% of customers did not generate enough sales to earn enough gross margin to cover even the variable cost of weekly sales visits and order deliveries. The combined annual variable losses were equal to the company’s annual profit. In order to address this, a minimum order size was implemented and low volume customers were moved to a lower cost call centre sales channel.

Where an organisation has already implemented ABC to fully cost products, substantial portions of this prior work can be used for customer focussed ABC.

 Relevant Costs

Good accounting and management practice dictates that only relevant costs should be considered in management decision making. That is, only costs that are incremental to the decision at hand are appropriate. Sunk costs and other costs that do not change based on the decision to be made are not relevant to the decision. This is often forgotten in the implementation of Activity Based Costing, often causing executives to throw away the hard work of the finance team by not using the information produced, or worse still, to make decisions that have a negative effect on the company.

One company started to exit its “unprofitable” customers, but found profits falling and more customers becoming unprofitable. A later analysis determined that many of the “unprofitable” customers had positive contribution margins (ie were covering the variable costs of servicing them and contributing to fixed costs). Reducing customer numbers did not reduce the head office, marketing and research costs allocated to these customers. Eliminating these customers therefore reduced profits, caused a higher level of fixed costs to be allocated to the remaining customers and lead to a death spiral in which all customers would ultimately be eliminated.

A customer profitability analysis must provide flexible data that enables the relevant costs for specific decisions to be identified. Whether costs are predominantly fixed or variable is key to this type of analysis. While some managers like to see all of a company’s costs allocated to products, it is vital that non-incremental costs are excluded from decision analysis.

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CONCLUSIONS

Management is becoming more and more aware of the need for customer profitability information to support decision making. Existing costing systems do not meet the needs for this information and finance departments are responding with a number of approaches.

Customer focussed activity based costing is an approach which takes into account the specific resources utilised to service each customer segment. Any customer profitability analysis must consider the relevant costs for the decision at hand in order to support value adding and avoid value-destroying decisions.

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