Are they *always* right?

Bob Scarlett

Customer profitability analysis can determine which of your company's patrons are most valuable to the business – and which of them aren't pulling their weight

Customer profitability analysis (CPA), according to the 2000 edition of CIMA's *Management Accounting Official Terminology*, is the "analysis of the revenue streams and service costs associated with specific customers or customer groups".

Say we have two customers, X and Y, who have generated similar revenues for our business over the past year. Both pay their bills on time and their revenue growth rates are comparable. We might think these customers are of equal value to our business, but X has been a customer for years, gives us all of his business, refers friends and associates, pays electronically and demands little in the way of extra attention. Y, on the other hand, has recently been reacquired for the third time in three years through significant price concessions. He buys our lowest-margin items, changes his orders at the last minute and requires a lot of customer care.

So are X and Y generating similar returns? Probably not, but a conventional management accounting system might not show this. Such a system seeks to determine the cost of individual products. Product costs are derived on the basis of an allocation of direct costs and an absorption of indirect costs using some base such as direct labour hours. A more advanced system might determine product costs on an activity basis, recognising that many costs are attributable only on a product- or batch-specific basis.

The problem is that many costs relate not to the products but to the way in which they are served to customers. Such costs may include those of selling and order-taking; distribution; discounts; marketing; admin; and quality control. Even some production and purchasing costs may be customer-specific, especially where goods are very customised and have a high service content. It's possible to attribute them to individual customers by using appropriate cost drivers. For example, selling and order-taking costs may be attributed on the basis of the number of sales visits to a customer. Once this is done, it is possible to report business performance on the basis of customer profitability.

CPA is likely to show that X is more profitable to us than Y. This may seem obvious, but it's not something that a traditional cost reporting system could be relied upon to disclose, given that customer-specific costs are likely to be treated simply as fixed overheads.

In recent years many firms have claimed to have moved from being "product-centric" to being "customer-centric". Customer relationship management (CRM) initiatives are usually at the forefront of their efforts. Their belief is that understanding customer behaviour and profitability is key to gaining a competitive advantage. CRM initiatives are associated with developments in both information systems and organisation. For example, financial services companies have reorganised themselves so that one person is responsible for delivering all products to given customers. At the same time, they have set up databases holding information on the firm's dealings with particular customers.

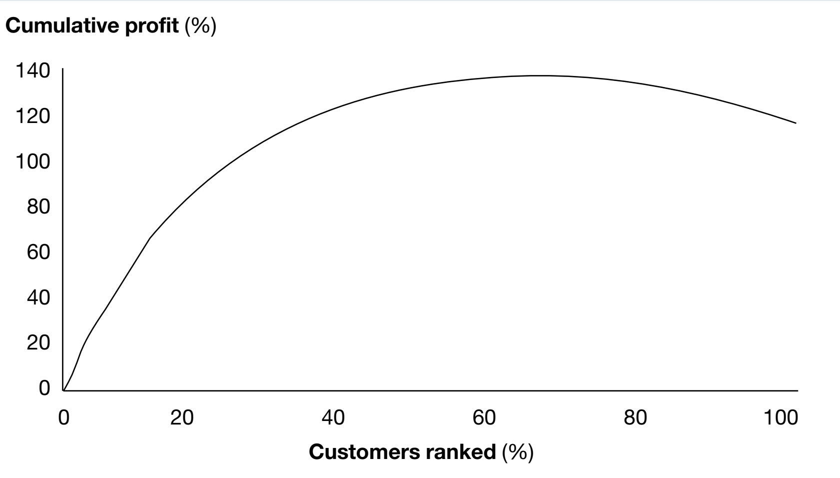
CPA is intended to provide a guide for actions to be taken through a CRM initiative. Its aim is to determine the profit margin generated by each customer. It's often found that a small number of customers generate a high proportion of the total profit, while the rest contribute little, as illustrated by the simple graph (left). This ranks customers by order of profitability and shows that:

- the first 20 per cent of customers account for 80 per cent of the firm's total profit;
- the next 40 per cent of customers generate a much smaller profit;
- the last 40 per cent of customers actually lose money for our business.

These findings may prompt obvious actions. Low-margin accounts can be treated in a number of ways. Sales to such customers can be automated or routed via brokers or wholesalers. In extreme cases, some accounts can be closed. But the customer-centred view of a business associated with CPA and CRM must have a long-term, strategic dimension. The crux of this is that loyal customers are more profitable over time. It costs less to serve them and they probably refer others to your business. They may also pay a premium to continue dealing with you rather than switch to an unfamiliar supplier. You therefore need to take a life-cycle approach to dealing with customers and potential customers.

CPA and CRM underpin a customer-centred, strategic approach to business, but they do not themselves provide it. A company cannot simply install a CRM database and expect the strategy to appear and start yielding results. ■

Customer profitability analysis



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