Are All of Your Customers Profitable (To You)?
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Executive Summary
Some customers purchase a mix of relatively low margin products. After adding the "costs-to-serve" those customers apart from the products, these customers may be unprofitable. For other customers who purchase a mix of relatively high-margin product, they may demand so much in extra services that they too could potentially be unprofitable. How does one properly measure customer profitability?

If two customers purchased from your company 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 behave like saints and others like sinners. Some customers place standard orders with no fuss, while others demand non-standard everything. Some customers just buy your product or service 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. In some cases, just the geographic territory the customer resides in makes the difference.

Employees often wonder if the bothersome or remote customer is worth it? What they are really asking is this. "If we added up all the costs of our time, effort, interruptions and disruptions attributed to those kinds of customers, in addition to the costs of the products and base service that that customer drew on, did we make any profit?" That is a good question. How do we know? How do we know the level of profitability of any or all of our customers? Most organizations do not. Since organizations are continuously pursuing prospects, they might want to know how profitable will they be relative to each other or to our existing customers?

The Pursuit of Truth About Profits
Why would you want to know these answers? Possibly to answer more direct questions about 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 sales volume justify the discounts, rebates or promotion structure we provide the customer?
- Can we realize our 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.

A competitive company must also ultimately translate its strategies into actions. For outright unprofitable customers, you would want to explore the possible options of raising prices, or surcharging them for the extra work. You may want to reduce the causes of your extra work for them, streamline your delivery so it costs you less to serve them, or finally alter their behavior so that those customers place less demands on your organization.

In Peter Francese's book, *Marketing Know-How*, he posed key questions around a customer/marketing model which basically instructs marketers to "follow the money!" Francese starts by asking what kinds of customers are loyal and profitable... and what kinds are only marginally profitable, or worse yet, losing you money. The good news is there is now a cost measurement methodology, called activity-based costing (ABC), which can economically and accurately trace the consumption of your organization's resource costs to those types and kinds and customer segments who place varying demands on you. Determining your "costs-to-serve" customers is logical with ABC.

Figure 1 shows the framework for how ABC traces, segments and re-assigns costs based on the cause-and-effect demands triggered by customers and their orders. ABC refers to these triggers as "activity drivers." When the cost of processing a customer's orders is subtracted from the sales for those orders, you can really know historically whether you actually made or lost money, and prospectively whether an accepted price quote will be profitable or not.
Employee Denial, Guilt And Resistance To Change

Here is an ironic question. Why would some people not want to have access to customer profitability data? 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; and besides that, 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!

In other situations, some employees are evaluated or incented based on sales volumes, so they don't place as much importance on costs and profits—just sales volume. Some employees believe that on average there is very little that distinguishes differences between customers, and they basically view customers as clones for each other. Some employees may think that for those customers who create more extra demands on work through their expedites, frequent small orders, slow-bill collection follow-up, difficult or distant access, and the like, those high-maintenance customers should be subsidized by the effort-free customers. These employees are not disloyal; they need awareness of how profits are generated and a change of their mindset.

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 cost to serve each of them. It is no longer acceptable to not have a rational system of assigning so-called non-traceable costs to their sources of origin.

Beneath The Iceberg: Unrealized Profits

What is the reality of profits and losses? 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 those in-between. But since pricing is usually determined (and quoted) based on average-based standards, those customer-driven imbalances are rarely reflected in the pricing.

When the inequities are replaced with true measures of the cost-to-serve customers, the companies who have performed this analysis have realized that they make a lot of profit on the winners and then give back quite a bunch on the losers. And both the profits and losses are usually big numbers. The company only banks the net difference. Although not empirically tested, experiences with these measures show that the total amount of the profits, excluding any losses, usually exceeds 200% of the resulting reported net profit—and greater than 10X has even been measured!

Figure 2 shows a graph of how unrealized profits can be hidden due to inadequate costing. The graph is of each product's cost, net of sales, to reveal each product's profit. The products are rank-sorted left-to-right by the most to the least profit margin rate. The very last data-point equals the firm's total net profit, as reported in their profit and loss statement. For this organization, total revenues were $20 million with total costs $18 million to net at $2 million; but the graph reveals the mix of that $2 million.
How can this be happening? How can such unrealized profits be so offset by the unprofitable products and customers? The major reason is no one sees it. Some people intuitively think it but can't prove it. In many organizations, the cost accounting system is referred to as “a bunch of lies that we all agree to.”

The traditional financial reporting in no way reveals the separate profit and losses for several reasons. (1) It examines and reports department level expenses but not on the work-efforts within a department; and (2) the non-direct product costs are allocated exclusively to products or base-services but rarely isolated and directly charged to specific customer segments. In financial accounting terms, the costs for selling, advertising, marketing, logistics, warehousing and distribution are immediately charged to the “time period” in which they occur. Consequently the accountants are not tasked to trace them to customer segments. Today’s selling, merchandising, and distribution costs are no longer trivial costs they are sizable. As an example, it now costs more for General Motors to sell its cars than to make its cars!

LSI Logic, a high-tech semiconductor manufacturer, performed ABC and discovered they were making roughly 90% of their profits from 10% of their customers. That alone is not unusual, but they were losing money on half of their customers. Upon discovering this, what LSI Logic did next was explain to some of their unprofitable customers how those specific customers could alter their own behavior to lessen the workload on LSI Logic so that a fair profit could be attained. The remaining unprofitable customers were “fired” -they were asked to take their business elsewhere as it was evident there was little hope that their sales would cover their costs. LSI Logic’s sales levels then predictably dipped, but profits tripled. The lesson is there is a “quality of profit” associated with sales volume and product mix; there should be a focus on the customer contribution margin devoid of cost allocations similar to the current focus of cost accounting on product profit margins.

**Structural Deficiencies With Traditional Financial Accounting**

The fact is that customers are the source of a much greater amount of work-creation than most people imagine. For wholesalers and distributors, one can argue that customers cause all of the work. And even once that is understood, traditional accounting systems are ill equipped to trace the costs. What is needed is to first accumulate the costs of the various support work activities for the order-fulfillment work, and then to assign this order-fulfillment work into the product and customers who cause work to happen in varying amounts -and in proportion to their use. Traditional financial accounting systems are structurally deficient to accomplish this.

Why? Traditional accounting only reports employee-related salary and fringe benefit costs, which reveal no insights to the content of work performed, which is controllable. Traditional accounting also groups costs according to the hierarchical and vertical appearance of the organization chart, denying any view of the true end-to-end business processes that start and finish with customers. Business processes are unaware of artificial organizational boundaries. In contrast, ABC flexibly defines and measures costs at the level of work activities, regardless of function. ABC then allows re-assembly and linkage of these same work activity...
costs to how each customer, channel and market segment consumes the costs to get served. With activity-based costing, the traditional profit and loss statement (P&L) changes and becomes more like the layers on an onionskin.

Figure 3 contrasts the traditional P&L with an ABC P&L. It shows a simple report revealing varying margin layers. The left side of the figure shows what most managers see today. Only the products are costed (and the product overhead costs are frequently misallocated to them). The right side ABC P&L shows that first, exclusively product-related margins can be viewed, and without the misleading distortions from overhead cost misallocations (traditional overhead cost allocations apply volume-based factors without correlation, and not use-based activity drivers possessing cause-and-effect relationships). Then, as customers consume (i.e., purchase) their unique quantities of the mix of products, where some products may be stand-alone profitable and some not at the product level, then the "cost-to-serve" customer-related costs are combined to calculate the next margin layer.

The Traditional Profit and Loss Statement will be replaced by an ABC P&L with its “layered” Gross Profit Margins

ABC/M Contribution Layering

A true ABC/M system operates as a re-assignment system. Let’s revisit Figure 1 reveals how the costs flow through the cost assignment network.

ABC is a Cost Re-Assignment Network

In complex, support-intensive organizations, there can be a substantial chain of support activities prior to and upstream from the work activities that eventually trace into the final cost objects. These chains result in activity-to-activity assignments, and they rely on intermediate activity drivers in the same way that final cost objects rely on activity drivers to re-assign costs into them based on their diversity and variation.

The direct costing of indirect costs is no longer, as it was in the past, an insurmountable problem given the entry of computerized ABC software that evolved in the early 1990s. ABC allows for intermediate direct costing to a local process output or to an internal customer or required component material that is causing the demand for work. That is, ABC cost flow designs no longer have to "hit the wall" from limited spreadsheet software and its restricted columns-to-rows math. The new generation of ABC software is arterial in design. Eventually via this cost assignment and tracing network, ABC re-assigns 100% of the costs into the final products, service lines, customers and business sustaining costs.

Let’s review the cost assignment network in Figure 1 beginning where customers (or beneficiary receivers) initiate the demands on work that ultimately requires resources to be consumed.
Starting at the bottom module, all organizations have customers that behave as final-final cost objects; their existence ultimately creates the need for a cost structure in the first place. For example, customers purchase varying quantities or amounts of the organization’s products or service lines. In some unique cases, different suppliers create differing demands on work for similar products, so the suppliers may also be segmented to reflect their variation. Note that the supplier’s total product or service line costs, although they may be identically priced as those of an alternative supplier, would now reflect different costs reflecting the varying ease or difficulty working with that supplier.

It is in this final cost object module where diversity is most apparent and into which all upstream activity costs flow.

Next, skipping past the middle module (i.e., activity costs) and moving up to the top module, the traditional general ledger expense balances are displayed. The cost assignment diagram in Figure 1 only reveals assignment paths from the payroll-related costs; but paths for the non-payroll expenses, such as supplies and operating expenses, also exist for any organization. These paths are simply not shown to reduce the complexity of Figure 1, but all of the non-payroll related resource costs also flow through the cost assignment network. Payroll-related costs are very important to ABC because they are the more controllable expenses. It is the activities performed by workers who use those resource costs that "drag" along and consume many of the other non-payroll resource costs such as supplies. (Figure 1 traces the ledger expense balances into a "staging" account of work groups, which in turn are re-assigned to the work activity costs using resource drivers, such as timesheets.)

The most important ABC module is arguably the middle one -the activity module. This module is not only where the work activity costs are initially costed, but where they are further re-assigned to the supplier, product, service line, customer or business sustaining final cost objects that collectively create demands on the organization’s work. Unfortunately, for many organizations, after they have expended the effort to define their work activities and calculate their activity costs, they stop there. Activity costs are the starting point of both ABC and ABM, not the end!

One of the insights gained from ABC/ M is an understanding of how final cost objects, such as products and customers, vary with the work-related activities that they consume. Some activities, such as opening a new customer’s account or placing a product into a box, vary directly with each specific customer or product (i.e., cost object) processed or serviced. These are called unit-level costs.

There are other activities, such as changing over machine settings in order to make a different product, that vary independently of the batch-size (quantity of the machine run volume). These kinds of work activities vary directly with each event when the machine is re-set. Another example, customer-related, is where the length of time processing a customer invoice is independent of the price of the invoice. These are referred to as batch-level costs.

Both unit-level and batch-level costs can be attributed to specific products or customers without debate since the products or customers are the final cost objects causing and consuming the work. There is third higher level activity cost type referred to as “sustaining” costs. Sustaining costs can be applied to the business as a whole*, to customers, to products, and to suppliers.

**Business Sustaining Costs**

*Business sustaining costs* are those costs not caused by products or customer service needs. The consumption of these costs can not be logically traced to products or customers. One example is the accounting department closing-the-books each month. How can one measure which product caused more or less of that work? One can not.

Another example is lawn maintenance. Which customers or products cause the grass to grow? These kinds of activity cost cannot be directly charged to a customer, product or service in any possible fair and equitable way; there is simply no "use-based " causality originating from the product or customer. The need to recover these costs via pricing or funding is eventually required, but that is not the issue here; the issue is fairly charging cost objects when no causal relationship exists.

*Business sustaining costs* (or organization sustaining for governments and not-for-profit organizations) can eventually be "fully absorbed" into products or customers, but such a cost allocation is blatantly arbitrary. There simply is no cause-and-effect relationship between a business sustaining cost object and the other final cost objects. When these costs are assigned into final cost objects, organizations often refer to them as a "management tax" representing a cost of doing business apart from the products and services.

Examples of final cost objects that comprise business sustaining cost objects may include: senior
management (at individual levels, such as corporate, division and local) or government regulatory agencies (such as environmental, occupational safety, or tax authorities). In effect, these organizations via their policies and compliance requirements or via their informal desires such as briefings or forecasts, place demands on work activities not caused by or generally attributable to specific products or customers.

Other categories of expenses that may be included as business sustaining costs may be idle capacity costs or research and development (R&D). R&D costs might be optionally assigned so that the timing of the recognition of expenses is reasonably matched with revenue recognition for sales of the products or service lines. However, remember that ABC is managerial accounting, not regulated financial reporting, so strict rules of generally accepted accounting principles (GAAP) do not need to be followed, but they can be borrowed.

Figure 4 expands on the ABC/M cost assignment network’s final cost object module. It displays two layers of “nested” consumption sequence of costs. A metaphor for this consumption sequence is the predator food chain from the animal kingdom. The final-final cost object, which in this figure is the customer, ultimately consumes all of the costs, except for the business sustaining costs.

Within each of the major final cost object categories (suppliers, product/service line, and customers), they each have their own “sustaining costs” which are assignable to their end product or end customer. However when tracing these “sustaining costs,” they cannot apply a measurable quantity volume as applied by the batch-level and unit-level activity costs. For example a branding program may benefit a select group of products, for which those products can be specified, but how much of the branding cost should be allocated to each product? These “product sustaining costs” can be traced using some “shared” basis, such as sales unit volume or spread evenly, even though there is no cause-and-effect.

In short, sustaining costs can be assigned to products or customers using what may appear as the old flaws of cost allocations. However this method of capturing diversity of mix at least segments and isolate the sustaining costs to the type of final cost objects that cause the activity costs to occur -and usually to a subgroup within that final cost object.

Additional Final Cost Object Types
In effect, what ABC/M does is reflect how the variation and diversity of cost objects segment activity costs and resource costs. If there are substantial costs and sufficient diversity in another type of cost object, for
example the type of customer order (standard, special, international, etc.), then the "order type" can qualify as its own separate and visible final cost object. It would serve as an intermediate repository to capture diversity of the type of work output. After activity costs are traced to these final cost objects, then those costs are re-traced to the customers based on the mix of order types consumed by each customer. "All customers are not created equal."

Figure 5 displays three potential cost object types that could be isolated and assigned as an intermediate destination for activity cost accumulation prior to being re-assigned to customers.

![ABC/M PROFIT CONTRIBUTION MARGIN LAYERING](image)

**ABC/M Predator Food Chain**

Note that without them being isolated, these activity costs would have been directly assigned to customers from the same activity costs. But by isolating them, via a two-step cost assignment method, the activity costs are grouped the way they match the work, and then the customer is shown to be "purchasing" the output. The second of the cost assignments are referred to as cost object drivers (the term "activity driver" is no longer applicable as the work activity already accumulated in the final cost object.)

Advanced ABC/M users may wish to view product profitability including customer costs (e.g., to print prices in their price list catalog). Today's advanced ABC/M software allows multidimensional views of various combinations of cost objects. A two-way bi-directional linkage replaces the sequence of the predator food chain. Other dimensions can include geographical sales territories, store locations, or specific salespeople.

**The ABC/M Customer Profit and Loss Statement**

As costs flow from one final cost object to another final cost object, each flow will consume the unique mix of the upstream cost object. That is, in simpler terms, an individual customer's total costs (apart from its direct cost-to-serve) are inclusive of only the product quantities and mix that it purchased. And each product incurred its costs with a cause-and-effect relationship, not with an arbitrary, indirect cost allocation.

Figure 6 reveals the "layering" of costs similar to Figure 3, but in the shape of a 3-D cube. The costs for each successive step along the "predator food chain" are inclusive of only the unique mix of costs that were purchased or consumed. The "structural drivers" provide the assignment bridge into the next successive level that consumes the upstream costs.

Figure 7 is an example of an individual customer profitability statement. There can be a P&L statement for each customer as well as logical groupings of customers. There can be a tremendous amount of detail that lies below each of these reports. For example, the individual products and service lines purchased can be examined as they are a mix of high and low margin on their own. And within each product or service line, the user can further drill down to examine the content and cost of the work activities and materials ("the bill of costs") for each product and service line. This is powerful information. The sum of all of the customer
Profit and loss statements for this type of report will sum to the entire business’ enterprise-wide profit (or loss).

Revelations From The New Cost Data

Note that in Figure 3 the three margin levels do not include any "business sustaining expenses," the

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**Figure 6**

3D ABC/M Profit Contribution Cube

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**Table: Customer: XYZ Corporation (Customer #1270)**

<table>
<thead>
<tr>
<th>Sales</th>
<th>Margin $ (Sales - ΣCosts)</th>
<th>Margin % of Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product-Related Supplier - Related costs (TCO)</td>
<td>XXXX</td>
<td>98%</td>
</tr>
<tr>
<td>Direct Material</td>
<td>XXX</td>
<td>50%</td>
</tr>
<tr>
<td>Brand Sustaining</td>
<td>XXX</td>
<td>48%</td>
</tr>
<tr>
<td>Product Sustaining</td>
<td>XXX</td>
<td>30%</td>
</tr>
<tr>
<td>Unit Batch</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Distribution-Related</td>
<td></td>
<td>28%</td>
</tr>
<tr>
<td>Outbound Freight Type*</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Order Type</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Channel Type</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Customer-Related</td>
<td></td>
<td>26%</td>
</tr>
<tr>
<td>Customer-Sustaining*</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Unit-Match*</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Business Sustaining</td>
<td>XXX</td>
<td>24%</td>
</tr>
<tr>
<td>Capital Charge**</td>
<td>XXX</td>
<td>8% Operating Profit</td>
</tr>
<tr>
<td>(Inventories, receivables)</td>
<td>XXX</td>
<td>6% Economic Profit (for EVA)</td>
</tr>
</tbody>
</table>

* Activity Cost Driver Assignments use measurable quantity volume of Activity Output (Other Activity Assignments traced based on informed (subjective) %).
** Capital charges can also be directly charged as imputed interest to products & cust.
company internal tax, which were not caused by products, base-services or customers. It is true that these
des. It is true that these
expenses must some way be recovered via pricing, but an ABC profit and loss statement reveals that they
do not necessarily have to be recovered by all products and by all customers.

This revelation can give progressive and innovative companies tremendous flexibility to: (1) price low for
emerging products and for targeted new customer prospects, and (2) price higher for more loyal and secure
customers less likely to switch to competitors. However, if too many prices are set slightly above the
"marginal costs," as time passes where products are phased-out and customers depart, then the profit
structure risks being slowly replaced without enough sales to recover the business sustaining costs. So this
practice must be carefully managed. For example, low prices to capture new customers will need to be
gradually increased over time.

The ratios of the "cost-to-serve-customers" to the product mix margin are revealing when compared on a
customer-by-customer basis (or by segment or channel). A traditional belief that large volume customers
produce proportionately large profits may be dispelled. Companies using ABC often discover that if given an
extra hundred dollars to "serve" a customer, it would return a relatively higher profit contribution from mid-
size or smaller customers.

**Migrating Customers to Higher Profitability**

Figure 8 provides a two-axis view of customers with regards to (1) the "composite margin" of what each
purchases (reflecting net prices to them), and (2) their "cost-to-serve." Each quadrant of the matrix shows a
different type of customer. Figure 8 debunks the myth that companies with the highest sales must also
generate the highest profits. This is not necessarily true!

![Figure 8: ABC/M Customer Profitability Matrix](image)

**Types of Customers**

- **Passive**
  - Production/service is crucial
  - Good trading partner

- **Savvy**
  - Pays top-shelf price
  - Costly to serve

- **Cheap**
  - Price-sensitive
  - Low service & quality requirements

- **Aggressive**
  - Leverage their buying power
  - Buying low-margin

**Product Mix**

- **High** (Creamy)
- **Low** (Low Fat)

**Cost-to-Serve**

- **Very Profitable**
- **Very Unprofitable**

Figure 9 shows various customers as points of an intersection of Figure 8's matrix. The objective is to make
all customers more profitable -represented by driving them to the upper-left corner. This can be
accomplished by: (1) managing their "cost-to-serve" to a lower level, (2) reducing their services, or (3)
raising prices or shifting the customers purchase mix toward richer, higher-margin products and service
lines. (Note that migrating customers to the upper left corner is equivalent to moving individual data-points
from right to the left in Figure 2, the profitability profile.)
Knowing where customers are located on the matrix requires ABC/M data.

**Beware The Learning Organization**

As progressive organizations, and some may be your competitors, gain proficiency and mastery with the business intelligence provided by ABC, they can be formidable. What those companies are recognizing is that each individual customer affects the profitability of their branded products, base services and market segments. The effect is due to the customer's purchasing habits, delivery location, discount/rebate structures or other diverse ways it places demands on a supplier. When equipped with ABC's superior data, they can cherry-pick the premium-profit customers, strategically price for new product entry, and even send "false-signals" with price quotes deliberately set at levels to lose the business so that their competitors will not suspect they have a far more accurate quoting engine.

Future competitive differentiation will be based on the rate at which organizations learn, not just the amount they learn. You do not want your organization to be too late in understanding and mastering ABC as the route to understanding your customer profitability.