

# **Profit Improvement Report**

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## **All Customers Are Not Created Equal**

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The management team in every firm is intuitively aware that all customers are not the same in terms of the profits they generate. Some customers purchase a lot of merchandise, others purchase only a little. In addition, some customers are aggressive price buyers while others are more interested in service. Qualitatively, some customers are easy to deal with, while others are a pain.

This intuitive awareness seldom translates into action, however. That is, few WASDA members treat the good customers better than they treat the bad ones. In terms of service, support and pricing, all customers are treated as equals.

Part of the problem is that without some sophisticated and time-consuming investigation, there is no way to know exactly how much better the good customers are than the bad ones. Without such information, the easiest path to follow is to give every customer the same pricing and service package. Such an approach often has very negative financial consequences.

This article will explore customer account management for WASDA members. It will do so from two perspectives:

- **The Profitability Difference**—It will provide insights into how much profit the typical WASDA member makes on different customers.
- **Account Planning**—This will provide a basis for taking specific action to generate the maximum profits from the accounts being serviced.

### **The Profitability Difference**

A specific customer profitability analysis project has never been conducted among WASDA members. However, similar groups of distributors have conducted such an analysis. They all came to the same conclusion—there are a few very profitable customers and a lot of marginal ones. This conclusion is

demonstrated in **Exhibit 1** which applies the research from other industries to WASDA economics.

According to the Statistical Report, the typical WASDA member has annual sales of \$25,000,000 and a pre-tax profit of \$1,125,000 or 4.5% of sales. Assuming that the typical firm generates \$10,000 of revenue per customer, the firm with \$25,000,000 in sales would thus service 2,500 accounts. Exhibit 1 suggests these figures hide a lot of variation.

The exhibit divides the customers into four groups. The A customers are the most profitable ones, while the D customers are the least profitable. It is important to note that these breakouts are not based upon sales, but rather upon the dollar profits the accounts generate. This reflects the margins generated on the accounts less the costs of selling, servicing and supporting the customers.

As can be seen, for the typical firm there are about 375 customers, or 15% of the total that are in the A (high profit) category. The critical factor is that these few accounts generate aggregate profits that are equal to the profits of the entire firm. It is a startling conclusion—15% of the customers provide 100% of the profits.

At the other end of the spectrum, there are a lot of D accounts; around 875 for a typical firm. These accounts collectively lose money for the distributor and not in a minor way. The combined losses on these accounts amount to \$506,250 which equals 45% of the total profit generated by the entire firm.

The theoretical implications of Exhibit 1 are obvious. If the firm eliminated 875 customers, its profits would increase by \$506,250 and the company would not have to do nearly as much work as it now does. Turning theory into a profit reality gets a little trickier, however.

### **Account Planning**

The challenge is to take the overview information from Exhibit 1 and turn it into action. This challenge is made extra difficult when there is no specific information on which customers actually fall into the A through D categories. While the challenges are daunting, they are not impossible to overcome.

Since there are something like 875 unprofitable accounts, identifying at least some of them should not be a challenge. Even without a customer analysis system it is usually easy to identify the customers who are probably unprofitable. These customers tend to have a couple of key characteristics. First, their gross margins are likely to be lower than other customers. Second, they increase the workload of the firm because they generate a lot of small orders, deliveries and returned goods.

The real undertaking in any customer analysis effort is taking action once the problem accounts have been found. In general terms, unprofitable customers will require one of two different actions—fire ‘em or fix ‘em. In practice, what is needed is a very little of the first action and a lot of the second.

The ones that should be fired are almost obvious. They tend to engage in a wide range of behavior that drives profit away. They often cherry pick from a number of different suppliers, they are aggressive price negotiators, they expect a lot of additional services from the firm and they tend to be error prone, with lots of returned goods, questions over billing and the like.

The concept of firing customers has become fashionable in recent years. However, it should be approached with caution. In most businesses, there are only about one to two percent of the accounts that should be fired. Taking the typical WASDA member again, this would translate into at most 50 accounts.

Finding the very few customers to fire is not a difficult task. The much more difficult undertaking is working with the customers who are unprofitable, but who could be made profitable if their behavior could be changed slightly. It requires a perspective that customers can be “managed” in a way that improves profitability for the customer as well as the WASDA distributor.

Such managing requires discipline in terms of price concessions on the margin side. It also requires working with the customer to develop more meaningful buying patterns on the expense side. Customers who place lots of small orders are not only increasing the costs of the distributor, they are increasing their own costs. There is a clear opportunity for mutual benefit in changing buying patterns. When combined with margin improvements the opportunity to increase profits on customers is enormous.

## **Moving Forward**

Customers are the very reason for every organization’s existence. However, oftentimes customers buy in ways that make it difficult, if not impossible, to produce a profit in servicing them. Every firm needs to make a concerted effort to identify those problem accounts and take direct action to improve the profitability in servicing them. The potential rewards in doing so are great. The firm is not only doing itself a favor, but also helping customers buy in a way that increases their profits as well.

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## **A Managerial Sidebar On Firing Unprofitable Customers**

Most firms do not want to even think about firing a customer. It doesn't make any difference how much money is being lost on the account. The thought of consciously suggesting a customer go away is simply too negative.

Part of the problem is the somewhat futile hope that some day the relationship will get better. There are also the very real issues of whether the account will merge with a good account, will change management or something else will happen to make the account more desirable in the future.

Because of these concerns, most firms take the approach of letting customers fire themselves. This involves a conscious change in the pricing matrix for these customers. By definition, customers are unprofitable because the gross margin earned on the account does not cover the costs of servicing the account. Reducing services is a somewhat uncertain process, so increasing prices provides the "easier" of the two options for covering expenses.

Most firms simply adjust prices upward in moderate, but measurable, increments systematically over time. The price increases should be properly transmitted to the account as a part of normal operations. At some point the customer either seeks an alternative supplier or becomes profitable for the distributor.

A number of firms have found that very few problem accounts actually do fire themselves. They continue to value the services being received from the distributor and accept the higher prices. They may shift an important sector of their purchases to other suppliers, but they do not entirely terminate the relationship.