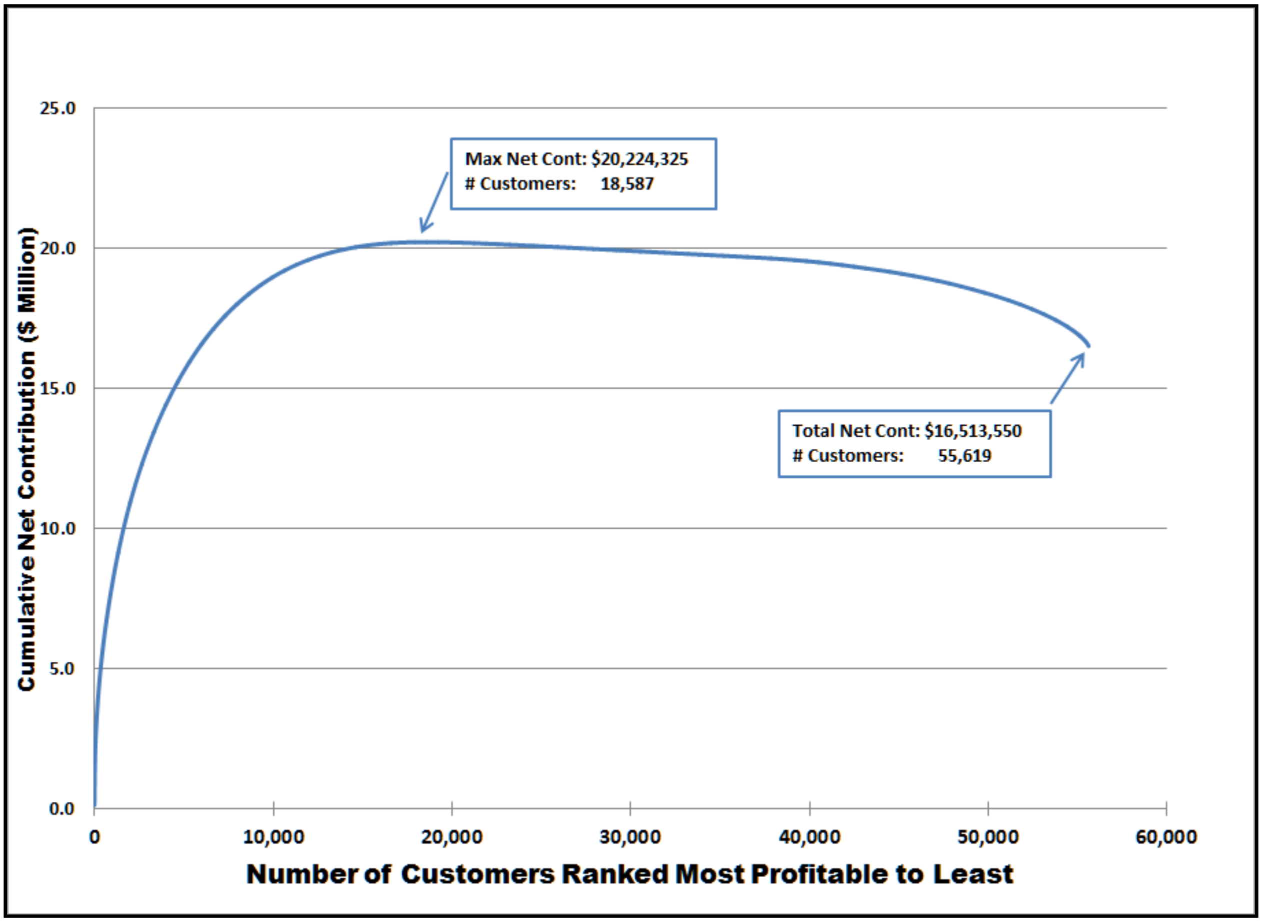
Customer Profitability is Painful but Worthy (not published)

Much has been written on the topic of Customer Profitability and its many theoretical benefits. But really, why should a company pursue this measurement approach given its requirements for advanced costing techniques and data detail? It is a costly endeavor that absorbs corporate resources and is challenged by employees' natural impulses to resist change. Why undergo all that pain based on academics' or consultants' assurances that it will be worth it? Trust us they say.

Well, for one reason, many executives are surprised to learn that the majority of their customers are break-even or unprofitable. That only 20% - 30% of their customers are profitable and create all of their company's profits and then some.

I have seen first-hand this tendency for most customers to be break-even or worse in the dozen plus customer profitability systems I have implemented at banks and credit unions, and I wrote about it in an earlier blog titled Banking Industry Myths Part 1, published in January 2016 at altavia.com. However, this phenomena applies across all industries and most companies as reported by Robert Kaplan and V.G. Narayanan in their groundbreaking research paper "Measuring and Managing Customer Profitability," *Journal of Cost Management*, September–October 2001.

One way to look at the impact break-even and unprofitable customers have on your organization is with a cumulative profitability chart, often called a whale chart, where customers are plotted from the most profitable to the most unprofitable. The following chart is from a mid-sized Credit Union based on their sophisticated customer profitability management system, which used advanced ABC costing techniques and monthly transactions by customer.



As can be seen from the chart, 18,587 customers at the credit union generated $20.2 million in profits, whereas 37,032 customers lost $3.7 million, yielding a net bottom line of $16.5 million for the year. That is, 33% of their customers generated 122% of the company's profits. The remaining 67% of their customers lost money for the company.

Two points from this chart are obvious: (1) if the credit union can turn the unprofitable 67% to merely break-even, their bottom line would increase by 22%; and (2) their 5,000 or so most profitable customers are ripe targets for the competition. But how would management even be aware of these issues if not for their customer profitability system? And how would they know which customers are which?

The most common metrics used by companies today hide these facts from management by averaging out their customers; for example, the average customer profitability for our credit union is a positive $297. Company total profits, product profitability, market penetration, sales by customer and so on cannot tell the tale of which customers are profitable and which are not. Only customer profitability based on advanced costing and customer behavior can give you the insights you need to truly manage your customer base. And let's not forget that profitable customers, current and future, are the source of all corporate value – and our jobs.