

## **Customer Segment Income Statements:**

### **Critical Management Information**

In an increasingly competitive business environment, customer service is critical. Often, however, management attempts to meet a customer's demands without reference to the profitability of that customer. A powerful management tool is the analysis of income statements and profitability reports based on customers or customer segments.

#### **Measuring the Value of Customer Based Reports**

To appreciate the value of customer based reports, consider these hypothetical examples. A manufacturer did approximately \$10,000,000 of business annually with 500 customers. The company discovered that their ten largest customers represented about 20% of their volume and 30% of their profits. Customers with sales in the \$25,000 to \$50,000 range had the highest rate of return on sales. Customers with less than \$10,000 in annual sales produced a loss of \$500,000.

Based on this information, management established a minimum annual sales level of \$10,000 for new customers and provided incentives to the sales force to target customers in the \$25,000-\$50,000 range. Also, management provided incentives to the sales force for any account under \$10,000 annually that was increased to above the \$10,000 threshold.

When a distributor analyzed his sales by customer, he discovered that certain products and customers were much more profitable than management thought and others much less so. Sales personnel had established cordial and accommodating relationships with favored customers, resulting in special services and too much attention, and in reduced profitability. Management changed the sales commission structure. Using the customer profitability analysis, sales commissions were increased for profitable customers and not paid at all for unprofitable ones.

#### **Implementing Customer and Customer Segment Income Statements**

The first step in applying this analytic technique is to segment customers into classes or categories. These may be by industry groupings, product groupings, or geographic groupings as well as a variety of other parameters. Segmentation at too high a level will produce little information of value, while segmenting at too low a level is overwhelming and makes it difficult to draw conclusions.

The income statement then should be segmented, with G/L accounts representing costs that can then be allocated among customer segments. Use both process and activity costs. The activity-based approach will make allocations simpler.

The assignment of costs is a multi-layered process. Certain *direct costs*, such as direct labor and direct materials can be assigned directly to the customer or segment. Other costs can be directly traced to the customer or segment (i.e. sales calls, expediting, and shipping.). Some costs have a causal relationship, but they are more difficult to assign, such as support and administration costs. Costs unrelated to the segment should be ignored in the analysis of segment profitability.

The final stage of this process is to get management and affected personnel to "buy-in" to the validity of the results. Only then can this information be effectively used to support decisions necessary to effect change and improvement.

This utilization of information technology is a service of McGill, Power, Bell & Associates, LLP that has our highest priority. Its purpose is to provide management with the customized information necessary to make decisions that will benefit the profitability of their businesses.

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*Editor's Note---John is a Partner in the Meadville Office, and specializes in the application of information technology to management information. John provides management level consulting in the use of information technology to several clients.*