

Uncover Your POCKETS OF PROFITABILITY



by Jeanne Rossomme

Profit-oriented business owners observe one of the most fundamental, but often ignored, rules of profitable growth - "All dollars are not green."

These owners always remember to apply the 80/20 rule to their customers, their markets, and their products to help them find the pockets of profitability that generate the most positive cash flow.

The 80/20 rule (or Pareto principle) postulates that 80% of the benefit comes from 20% of the effort. Many businesses apply this common sense principle to find ways to save money, and the rule generally holds true. But many owners forget this rule works just as well when it comes to finding ways to make money—to maximize profit growth and cash flow.

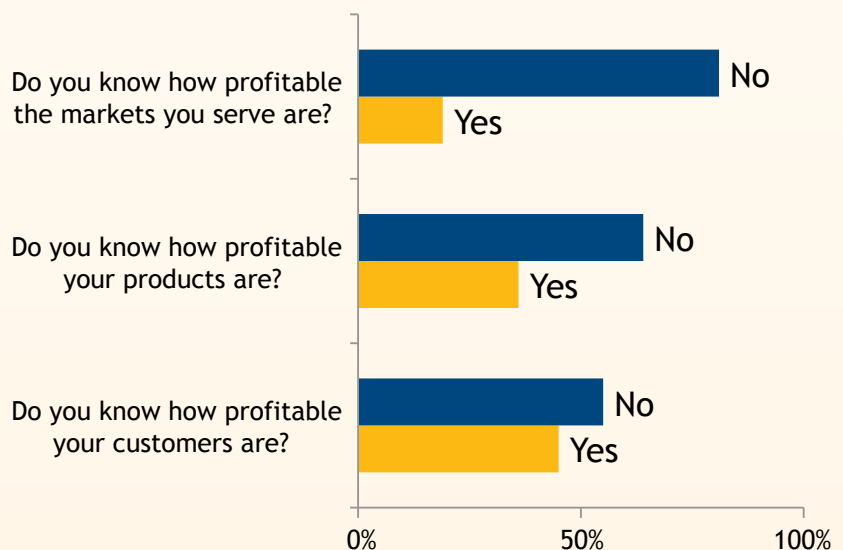
If they looked, most owners would find they have unprofitable customers and products. For example, a small technology company analyzed their product profitability and found that while most of their sales came from IT support services, security systems were actually four times as profitable. By shifting more marketing energy to selling security systems, this company could make more profit with exactly the same resources.

Knowing your pockets of profitability helps improve cash flow because it helps you focus your spending on the products, customers, and markets that are creating profits, instead of those that are costing you time and money. Also, if cash is very tight, one of the quickest ways to free up time and money while still making a profit is to actively manage your most unprofitable customers. This can be done by raising prices, changing terms and

renegotiating contracts to reflect your true economics. You might also consider cutting back or even dropping your most unprofitable product lines.

Unfortunately, most business owners do not take the time to look for their pockets of profitability. In fact, SunTrust research shows that the majority of owners are not tracking their profits by market, customer, or product line⁵.

Most Business Owners are not Tracking the Profitability of Their Customers, Products, and Markets



Source: SunTrust survey of business owners

Five Steps for Identifying Your Pockets of Profitability with Your Accounting System

Finding the pockets of profitability in your business can be as simple as asking your accountant to set up accounting software such as QuickBooks® to look at both the sales and costs associated with your customers and products.

Bookkeeping and accounting are generally viewed as overhead or non-revenue generating functions. But your accounting data is really the knowledge base of your company. The results of all of your company's operations (good and bad) show up in the financials. Here, you have a gold mine of information on customers, purchase habits, and cycles - and the costs associated with delivering value to these customers. If your accounting database is designed properly, you can drill down into this untapped reservoir to uncover pockets of profitability - the areas where you should focus your time, capital and talent. Properly structuring your accounting and financial reporting database can create a real strategic asset for your business.

Your accounting data and financial reporting systems should be able to provide you with the standardized reports that answer these key questions:

- What market segments or customer groups are most profitable and which are the most price sensitive?
- Who are your company's most profitable customers and which customers actually cost you money?
- What are your company's most profitable products and/or services? Which are your loss leaders?
- Which customers, products, and services offer you the greatest future value?

To set up your Accounting System to find your top sources of profit and cash flow, follow these steps with the Pockets of Profitability worksheet (found at the end of this article).



Step 1: Use accounting history to create meaningful customer groups

Your first step is to make your accounting system specific and meaningful to your business and your drivers of growth. Before starting, it may be helpful to look at each customer and sale from the past year looking for common characteristics to form natural groupings. You can also look at job proposals to help you think about business you competed for and your success rates in landing different types of customers and jobs.

With this history in mind, you can now create categories for customer groups. The key is to create enough categories so you can mine your accounting data for opportunities, but not so many that the data is difficult to gather and track on an ongoing basis.

a) Form meaningful top-level customer categories such as the following:

- By Ownership (Government vs. Business vs. Consumers)

FIVE PRACTICAL STEPS YOU CAN TAKE TO FIND YOUR POCKETS OF PROFITABILITY



Use accounting history to create meaningful customer groups



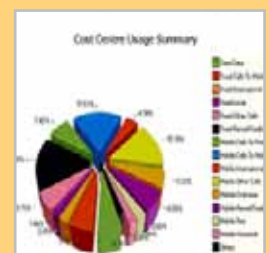
Start rating and tracking your marketing efforts and customer loyalty



Decide on product or service groupings



Assign direct costs to customers and jobs to track profitability



Use customer, product or service level financial reports to focus on pockets of profitability

- By Industry
- By Size (Revenue, number of employees, Income)
- By Distribution (Online vs. Retail vs. Wholesale)
- By Purchase frequency
- By Demographics (Age, Gender, Ethnicity, Lifestyle)

b) If you wish, form subcategories to further classify your customers. For example, you may designate a top category (like Online vs. Retail) and a sub-category (like Size) under the main category. You can get into several levels beyond this, but it is better to start simply so you can stay consistent.

c) Create consistent definitions for each top and sub category and document them clearly for anyone who enters customer information into your system.



Step 2: Start rating and tracking your marketing efforts and customer loyalty

Also, while you are thinking about customer types, start tracking data that will help you measure and refine your marketing efforts. For each customer, include additional characteristics (apart from sales and expenses) that identify how you attained this client and how much this client promotes your business. For each client, consider tracking the following information:

- Source: What marketing program or referral source led this client to you?
- Referrals given: How many clients has this client referred to your business?
- Customer Satisfaction rating (if applicable)

- Participation in customer forums
- Leadership roles in the industry



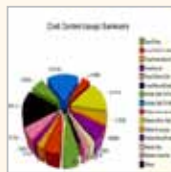
Step 3: Decide on product and/or service groupings

By using the same grouping process as described above for customers, you can identify the groups of products and services to track. Again, it is best to keep it simple at the beginning with no more than 3-5 top categories and sub-categories within each group as necessary.



Step 4: Assign direct costs to customers and jobs to track profitability

Most businesses track basic direct cost information such as labor and materials. Build on this by having your accountant set up your accounting structure to assign direct costs to jobs and customers. Work with your accounting staff to revise how direct cost data is gathered to tie it to specific jobs (for example, revising time sheets to tie hours to specific jobs and customers). You can then easily assess the profit margins on specific customers, products, and services.



Step 5: Use customer, product, or service level financial reports to focus on pockets of profitability

With your newly organized database, you will be able to generate profit and loss statements at a job and customer level. By filtering these reports based on the

categories you have developed, you can now quickly and easily generate reports showing profit margins by customer group, customers, products, and services.

To leverage this information, use company forecasts, industry data, and competitive analysis to establish benchmarks (e.g., targeted sales size, targeted profit margin on each service sold, employee efficiency ratios, etc.). Put a stake in the ground by establishing minimal levels of acceptable profit contributions by customer and by product or service. Compare your actual profit margins by customer, products, and services to forecasts and benchmarks on a periodic basis throughout the year.

Exploiting Your Pockets of Profitability

Fill out your decisions in the Pockets of Profitability Worksheet (on the next page) and provide this to your accountant or financial manager. Once the accounting system is modified, edit your customer profiles immediately to include the new grouping data (market segment, source, etc.). Product and service data will be gathered over time as you proceed.

Now you have the data to focus on those groups of customers, products, and services that generate the most profits. You can also look for strategies to reduce costs with customers or products that are not making you money. For example, many airlines have structured their level of customer service and response time based on the profitability rating of a particular customer. You can now use this same approach to decide the level of attention and resources you will provide to each customer, product, and market segment.