COAST DISTRIBUTING COMPANY
CASE STUDY

The Income Statement for Coast Distributing Company for one month is shown below. It is typical of those received by most business owners from their bookkeepers or accountants.

INCOME STATEMENT		
	Amount	**Percent Of Sales**
Sales	18,000	100.0%
Cost Of Sales	11,900	66.1%
Gross Margin	6,100	33.9%
Variable Operating Expenses		
Sales Calls	805	4.5%
Order Processing	1,525	8.5%
Deliveries	828	4.6%
Return Processing	1,735	9.6%
Credit Card Fees	120	0.7%
	5,012	27.8%
Fixed Costs	800	4.4%
	5,812	32.3%
Net Income	288	1.6%

According to the statement, Coast earned $288 on sales of $18,000. Although profitable, earning 1.6% on sales suggests that there's probably room for improvement. Based on the income statement, what steps would you take to improve Coast's performance? If you're like most business owners, you're stumped, thinking there's not much information here for you to work with. And you're right – you're faced with a dilemma most owners find themselves in when they try to use their financial statements to make sense of their company's performance.

Making decisions with incomplete information can be dangerous.
Today most companies have bookkeeping software systems that show how much has been sold to each customer, along with individual cost of sales and gross profit amounts. Following is an expanded version of Coast's Income Statement, this time including sales, cost of sales, and gross margin amounts for each of its three customers.

INCOME STATEMENT									
INCLUDING INDIVIDUAL CUSTOMER GROSS MARGINS									
			LARRY		MOE		CURLY		
	Amount	Percent Of Sales	Amount	Percent	Amount	Percent	Amount	Percent	
Sales	18,000	100.0%	8,000	100.0%	6,000	100.0%	4,000	100.0%	
Cost Of Sales	11,900	66.1%	5,200	65.0%	3,900	65.0%	2,800	70.0%	
Gross Margin	6,100	33.9%	2,800	35.0%	2,100	35.0%	1,200	30.0%	
Operating Expenses									
Sales Calls	805	4.5%							
Order Processing	1,525	8.5%							
Deliveries	828	4.6%							
Return Processing	1,735	9.6%							
Credit Card Fees	120								
	5,012	27.8%							
Other Costs	800	4.4%							
	5,812	32.3%							
Net Income	288	1.6%							

With more information to work with, we see that Larry is Coast's largest customer in terms of sales, gross margin dollars, and gross margin percent and that Curly buys the least and has the lowest gross margin percent.

Armed with this information, Coast's owners lavish attention on Larry, thinking he's their best customer, and ignore Curly thinking he's not worth their time. Given this information, many companies assume that Larry and Moe are valuable customers and that Moe is not. How would your business treat Moe?

Few companies have bookkeeping systems that gather customer-by-customer transactional data, even though doing so is the only way to determine each one's profit contribution.

Studies have shown that most companies subsidize between 15% - 40% of their customers, actually losing money on every sale they make to them. The cause of this disparity is that different customers behave differently, requiring differing levels of service and buying products and services with varying gross margins. Coast is no exception!

Following is a breakdown of the monthly transaction costs Coast incurred for each of its three customers.

MONTHLY TRANSACTIONS COSTS					
Cost Per Transaction					
	$ 115.00				
Sales Calls	$ 18.15				
Process Orders	$ 10.35				
Deliveries	$ 41.30				
Process Returns					
Number Of Transactions Per Month					Adjusted
	LARRY	**MOE**	**CURLY**		**MOE**
Sales Calls	2	4	1		2
Process Orders	20	60	4		20
Deliveries	20	60	-		20
Process Returns	10	30	2		10
	LARRY	**MOE**	**CURLY**	**TOTAL**	
Sales Calls	$ 230	$ 460	$ 115	$ 805	$ 230
Order Processing	$ 363	$ 1,089	$ 73	$ 1,525	$ 363
Deliveries	$ 207	$ 621	$ -	$ 828	$ 207
Return Processing	413	$ 1,239	$ 83	$ 1,735	$ 413
Credit Card Fees @2,00%	$ -	$ 120	$ -	$ 120	$ -
	$ 1,213	$ 3,529	$ 270	$ 5,012	$ 1,213

As the statement shows, Moe costs nearly three times as much to service as does Larry while Curly's service costs are very low. These are facts that can't be known without customer transaction data. To see how Moe's buying behavior affects Coast's profitability, take a look at the income statement when the costs to service each customer are included.

CUSTOMER BY CUSTOMER CONTRIBUTION MARGINS								
	LARRY		**MOE**		**CURLY**		**TOTAL**	
	Amount	**%**	**Amount**	**%**	**Amount**	**%**	**Amount**	**%**
Sales	8,000	100.0%	6,000	100.0%	4,000	100.0%	18,000	100.0%
Cost Of Sales	5,200	65.0%	3,900	65.0%	2,800	70.0%	11,900	66.1%
Gross Margin	2,800	35.0%	2,100	35.0%	1,200	30.0%	6,100	33.9%
Operating Expenses								
Sales Calls	230	2.9%	460	7.7%	115	2.9%	805	4.5%
Process Orders	363	4.5%	1,089	18.2%	73	1.8%	1,525	8.5%

Deliveries	207	2.6%	621	10.4%	-	0.0%	828	4.6%
Process Returns	413	5.2%	1,239	20.7%	83	2.1%	1,735	9.6%
Credit Card Fees	-	0.0%	120	2.0%	-	0.0%	120	0.7%
	1,213	15.2%	3,529	58.8%	270	6.8%	5,012	27.8%
Fixed Costs							800	4.4%
							5,812	32.3%
Net Income	1,587	19.8%	(1,429)	-23.8%	930	23.2%	288	1.6%

What a surprise! Coast actually lost money on Moe, spending $1,429 more to get his business than they received. What a shock to also discover that Curly is a profitable and valuable customer. Most business owners are absolutely amazed when given this kind of information.

Once the money-loser is identified, there are two possible ways to improve Coast's profitability. They can either stop selling to Moe or change the way they do business with him.

Following is the Coast Distributing Company Income Statement showing the increase in profit if they stop selling to Moe.

INCOME STATEMENT								
CUSTOMER BY CUSTOMER CONTRIBUTION MARGINS (WITHOUT MOE)								
	LARRY		MOE		CURLY		TOTAL	
	Amount	%	Amount	%	Amount	%	Amount	%
Sales	8,000	100.0%	-	0.0%	4,000	100.0%	12,000	100.0%
Cost Of Sales	5,200	65.0%	-	0.0%	2,800	70.0%	8,000	66.7%
				0.0%				
Gross Margin	2,800	35.0%	-	0.0%	1,200	30.0%	4,000	33.3%
Operating Expenses								
Sales Calls	230	2.9%	-	0.0%	115	2.9%	345	2.9%
Process Orders	363	4.5%	-	0.0%	73	1.8%	436	3.6%
Deliveries	207	2.6%	-	0.0%	-	0.0%	207	1.7%
Process Returns	413	5.2%	-	0.0%	83	2.1%	496	4.1%
Credit Card Fees	-	0.0%	-	0.0%	-	0.0%	-	0.0%
	1,213	15.2%	-	0.0%	270	6.8%	1,483	12.4%
Other Costs							800	6.7%
							2,283	19.0%
Net Income	1,587	19.8%	-	0.0%	930	23.2%	1,717	14.3%
Prior Net Income	288							

(With Moe)								
New Net Income (Without Moe)	1,717							
Net Income Increase	1,429							
Net Income Increase Percent	597%							

As the statement shows, net income goes from $288 to $1,717 when ABC stops subsidizing Moe, an increase of 597%.

Although it can be argued that some of the operating expenses would continue to occur even if Moe were not a customer, in reality there are almost always significant expense savings to be realized when money-loser customers are eliminated.

It's almost always better to turn money-loser customers into profitable ones instead of cutting them off. To demonstrate the results that can be achieved, the last financial statement in this case study shows how much Coast's profits increase when Moe's relationship is restructured so that his service costs are equal to Larry's.

INCOME STATEMENT								
CUSTOMER BY CUSTOMER CONTRIBUTION MARGINS (WITH MOE RESTRUCTURED)								
	LARRY		MOE		CURLY		TOTAL	
	Amount	%	Amount	%	Amount	%	Amount	%
Sales	8,000	100.0%	6,000	100.0%	4,000	100.0%	18,000	100.0%
Cost Of Sales	5,200	65.0%	3,900	65.0%	2,800	70.0%	11,900	66.1%
Gross Margin	2,800	35.0%	2,100	35.0%	1,200	30.0%	6,100	33.9%
Operating Expenses								
Sales Calls	230	2.9%	230	3.8%	115	2.9%	575	3.2%
Process Orders	363	4.5%	363	6.1%	73	1.8%	799	4.4%
Deliveries	207	2.6%	207	3.5%	-	0.0%	414	2.3%
Process Returns	413	5.2%	413	6.9%	83	2.1%	909	5.0%
Credit Card Fees	-	0.0%	-	0.0%	-	0.0%	-	0.0%
	1,213	15.2%	1,213	20.2%	270	6.8%	2,696	15.0%
Fixed Costs							800	4.4%
							3,496	19.4%
Net Income	1,587	19.8%	887	14.8%	930	23.2%	2,604	14.5%
Prior Net	288							

Income (With Moe)								
New Net Income (Moe Restructured)	2,604							
Net Income Increase	2,316							
Net Income Increase Percent	905%							

By getting Moe to reduce his number of transactions down to Larry's level, Coast's net income jumps from $288 to $2,604, an increase of 905%.

There are several ways to restructure Coast's relationship with Moe. Oftentimes, simply going over the numbers with the customer and suggesting ways to cut costs is productive. For example, getting Moe to consolidate his orders would reduce order processing and delivery costs. Other possibilities include billing for services, establishing a minimum order amount, adding a delivery charge, or employing some other tactic that recovers enough of the excessive service costs to make the relationship profitable – not just break-even, but profitable.

This case study has intentionally been kept simple. Few businesses exist with only three customers. The point it makes is that having data and knowing how much it costs you to serve each of your customers is extremely valuable. Without question, once you have a system in place to gather it, you'll start benefiting in two ways. You'll find groups of customers that you're subsidizing and will be able to rework your deals with them so they become profitable or at least stop costing you money. Even more important, you'll find a group, or groups, of customers who are extraordinarily profitable. Once you've identified them, you'll know how to target your marketing efforts for maximum profit.

Selling to money-loser customers is costing you a fortune. So is not being able to target high-profit sales prospects. Your relationships with your customers must be profitable if your business is to succeed and grow. You may think that this case study is an extreme example – that you have no customers who require the service levels of Moe. Maybe so. However, compiling customer transaction data and KNOWING what you earn from each one is vital to maximizing your company's earnings. Applied knowledge is power. What would doubling, tripling or even quadrupling your net income do for your business and its market value – not to mention your own financial security and peace of mind.

Note: Transaction costs are based upon today's typical market rates. To get a copy of the worksheets for calculating these per transaction costs, request a Coast Distributing Company transaction cost template.

CUSTOMER PROFITABILITY CALCULATION EXAMPLE			
CALCULATION OF SALES CALL COST		**CALCULATION OF COST OF SALES RETURN**	
SALESPERSON SALARY/COMMISSION	72,000	COST OF PROCESSING ORIGINAL SALE	18.15
PAYROLL BENEFITS @ 20%	14,400	COST TO PROCESS RETURN TRANSACTION	18.15
AUTO ALLOWANCE	6,000	REPACKING MATERIALS COST	5.00
PROMOTION ALLOWANCE	6,000	TOTAL COST PER RETURN	41.30
TELEPHONE	3,600		
SALES COLLATERAL	6,000	OTHER ASSOCIATED RETURN COSTS	
SALES TOOLS (COMPUTER, ETC.)	2,400	REPACKAGING COSTS	2.00
TOTAL SALESPERSON COST	110,400	RESTOCKING COSTS	1.00
		DAMAGE CLAIM FILING AND PROCESSING	2.00
4 SALES CALLS PER DAY		**INVENTORY OVERSTOCK**	-
WORK DAYS PER YEAR	240	RETURN TO SUPPLIER/FACTORY	-
CALLS PER DAY (20 DAYS PER MONTH)	4	FREIGHT COST TO SUPPLIER/FACTORY	-
TOTAL CALLS PER YEAR	**960**	**SUPPLIER/FACTORY RESTOCKING FEES**	-
			5.00
COST PER CALL	**115.00**		
		DELIVERY COST PER ORDER	
CALCULATION OF ORDER PROCESSING COST		PAYROLL COST	
INSIDE SALES PAYROLL		DELIVERY DRIVER SALARY	36,000
INSIDE SALES SALARY	60,000	PAYROLL BENEFITS @ 20%	7,200
PAYROLL BENEFITS @ 20%	12,000	TOTAL PAYROLL COST	43,200
TOTAL PAYROLL COST	72,000		
		VEHICLE COST	
WORKDAYS PER YEAR	240	ANNUAL MILES	24,000
ORDERS PROCESSED PER DAY	20	VEHICLE PURCHASE COST ($36,000 - 3 YEARS)	12,000
ORDERS PROCESSED PER YEAR	4,800	FUEL ($4.25/GAL. - 20 MPG)	5,100
		MAINTENANCE	1,800
PAYROLL COST PER ORDER	15.00		18,900
MATERIAL COST PER ORDER		TOTAL DELIVERY COST	62,100
INVOICE FORM	0.50		
PACKAGING MATERIALS	1.00	DELIVERY DAYS PER YEAR	240
MATERIAL COST PER ORDER	1.50	DELIVERIES PER DAY	25
		TOTAL DELIVERIES PER YEAR	6,000
OFFICE PAYROLL COST			
OFFICE SALARY	**33,000**	TOTAL COST PER DELIVERY	10.35
PAYROLL BENEFITS @ 20%	6,600		

TOTAL PAYROLL COST	**39,600**		
WORKDAYS PER YEAR	240		
ORDERS PROCESSED PER DAY	100		
ORDERS PROCESSED PER YEAR	24,000		
OFFICE PAYROLL COST PER ORDER	1.65		
TOTAL PROCESSING COST PER ORDER	**18.15**		