

# Are All of Your Trading Partners “Worth It” to You?

It is no longer sufficient for your organization to simply be lean, agile, and efficient. Your entire supply chain must also perform like you do. If some of your trading partner suppliers and customers are excessive high-maintenance to you, then they erode profit margins. Who are they, and how much do they drag down margins? How does one properly measure customer and supplier profitability? How does one de-select or “fire” a customer or a supplier? To be competitive, a company must know its sources of profit and understand its cost structure.

## All Customers and Suppliers are Not Created Equal

If two customers purchased from your company the exact same mix of products and services at the exact same prices during the exact same time period, would they be equally profitable? Of course not. Some customers behave like saints and others like sinners. Some customers place standard orders with no fuss, while others demand non-standard everything. Some customers buy your product or service and you hardly hear from them, while others you always hear from – and it is usually to change their delivery requirements, inquire about and expedite their order, or return or exchange their goods. In some cases, just the geographic territory the customer resides in makes the difference.

Employees often wonder if the bothersome or remote customer is worth it. What they are really asking is this: If we added up the costs of our time, effort, interruptions, and disruptions attributed to those kinds of customers, in addition to the costs of the products and base services that that customer drew on, did we make any profit? That is a good question. How do we know? How do we know the level of profitability of any or all of our customers? Most organizations do not. Since organizations are continuously pursuing prospects, they might want to know how profitable they will be relative to each other or to our existing customers.

Employees can ask a similar question about the inbound costs from their suppliers. Are some suppliers so much more difficult to work

with that they ultimately drag down the organization’s profits?

If all of these “extra” costs are passed on to customers by ultimately increasing prices to the end-consumer, what is the risk that our entire supply chain has finally pushed the consumer to switch to a substitute or a competitor’s product, or postpone their purchase altogether? That means lost sales to everyone. It is no longer sufficient for your organization alone to be lean, agile, and efficient. Your entire supply chain must also perform efficiently.

## The Pursuit of Truth About Profits

Why would you want to know answers for what your employees are asking? Possibly to answer more direct questions about your customers and suppliers, such as:

- Do we push for volume or for margin with a specific customer?
- Are there ways to improve profitability by altering the way we package, sell, deliver, or generally service a customer?
- Does the customer’s sales volume justify the discounts, rebates, or promotion structure we provide that customer?
- Can we realize benefits from changing strategies by influencing our customers to alter their behavior to buy differently (and more profitably) from us?
- Can we shift work to or from our suppliers based on who is more capable?

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To be competitive, a company must know its sources of profit and understand its cost structure. A competitive company must also ultimately translate its strategies into actions. For outright unprofitable customers, you would want to explore the possible options of raising prices, or surcharging them for the extra work. You may want to reduce the causes of your extra work for them, streamline your delivery process so it costs you less to serve them, or finally alter their behavior so that those customers place fewer demands on your organization.

In Peter Francese's book, *Marketing Know-How*, he posed key questions around a customer/marketing model that basically instructs marketers to "follow the money!" Francese starts by asking what kinds of customers are loyal and profitable – and what kinds are only marginally profitable, or, worse yet, are losing you money. The good news is there is now a cost measurement methodology called activity-based cost management (ABC/M) that can economically and accurately trace the consumption of your organization's resource costs to those types and kinds of channels and customer segments who place varying demands on you. Determining your "costs-to-serve" customers is logical with ABC/M. ABC/M also traces the consumption on you by varying supplier behavior; high maintenance suppliers erode your margins as well.

Figure 1.0 shows the framework for how ABC/M traces, segments, and re-assigns costs based on the cause-and-effect demands triggered by customers and their orders. ABC/M refers to these triggers as "activity drivers." When the cost of processing a customer's orders is subtracted from the sales for those orders, you can know historically whether you made or lost money. You will also know whether or not an accepted price quote for a future customer order will be profitable or not.

### Employee Denial, Guilt, and Resistance to Change

Here is an ironic question. Why would some people not want to have access to customer profitability data? Some

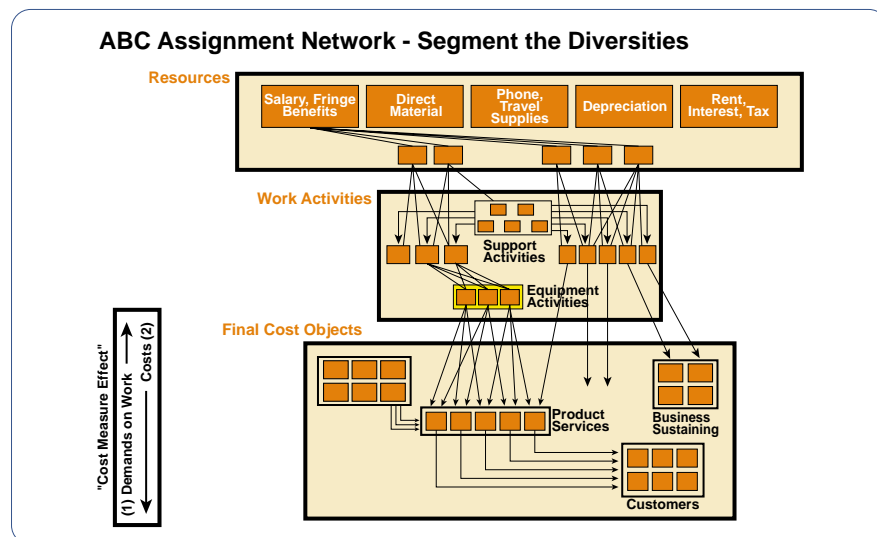


Figure 1.0 The ABC/M framework

employees intuitively suspect the truth – that there are losers – but these employees will likely presume that their companies would never want to "drop" those customers; they also perceive that those customers still provide sales volume that somehow "covers the overhead." But all the product costs, base service costs, and unrecognized extra costs may not be fully recovered by the sales prices!

In other situations, some employees are evaluated or incited with commissions that are based on sales volumes, so they don't place as much importance on costs and profits – only on sales volume. Some employees believe that on average there is very little that distinguishes any differences between customers, so they basically view customers as clones of each other. Some employees may think that those customers who create extra demands on work through their unwelcome expedites, frequent small orders, slow-bill collection follow-up, difficult or distant access, and the like, those high-maintenance customers should be subsidized by effort-free customers. These employees are not disloyal – they need education on how profits are generated, and a change of mindset.

The issue here is not only determining the profit contribution of customers, including "accurate" costs for the products

they buy, but also understanding the elements of customer-specific work that comprise the entire costs to serve each of them. Your suppliers can be similarly viewed; those who cause you extra work are ultimately dragging down the profit margin from your customers. It is no longer acceptable not to have a rational system of assigning so-called non-traceable costs to their sources of origin – whether those sources be suppliers, products, or customers.

Finally, your advanced suppliers may very well be examining you this same way. Are you a high maintenance customer to them? Might they be considering "firing" you because you are not worth it to them?

### Beneath the Iceberg: Unrealized Profits

What is the reality of profits and losses? When companies take the time to define and measure their in-house work activities and directly associate them to the bigger and smaller consumers of their work, the obvious occurs. In addition to the products and base-services provided to customers, there are big users, small users, and those in between other portions of your workload. But since pricing is usually determined (and quoted) based on average-based standards, those customer-driven imbalances are rarely reflected in the pricing. High-maintenance and low-

### Profitability Profile Using ABC

Profitability profiles are like electrocardiograms of a company's health. After sales are attached to the ABC costs, this graph reveals that \$8 million was made on the most profitable 75% of products - and then \$6 million was conceded back!

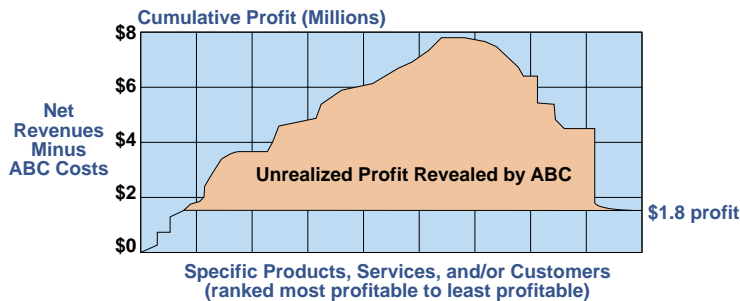


Figure 2.0 The effects of inadequate costing methods

maintenance customers are equally priced and reported as equally profitable; this is not accurate.

When the inequities are replaced with true consumption measures of the “costs-to-serve” customers, the companies who have performed this analysis realize that they make a high profit on the winners but simultaneously give back a great deal of unrealized profit on the losers. Both the profits and losses are usually big numbers. The company only banks the net difference. That is the “bottom-line” profit number that senior management sees. Although not empirically tested, experiences with these measures show that the total amount of the profits, excluding any losses, usually exceeds 200% of the resulting reported net profit – and greater than 10 times has even been measured!

Figure 2.0 illustrates how unrealized profits can be hidden by inadequate costing methods. The accountants are not properly assigning the expenditures based on cause and effect. The graph shows each product's cost and net of sales, and reveals the profit of each product and service line. The products are rank-sorted left-to-right by the most to the least profit margin rate. The very last data point equals the firm's total net profit, as reported in their profit and loss statement. For this organization, total revenues were \$20 million with total

costs \$18 million to net at \$2 million; but the graph reveals the mix of that \$2 million. The last data point “foots-and-ties” as the total reported profit, but gives no visibility to the parts.

How can this be happening? How can such unrealized profits be so offset by the unprofitable products and customers? The major reason is that no one sees it. Some people intuitively believe it, but they can't prove it. In many organizations, the managers refer to their cost accounting system as “a bunch of fictitious lies – that we all agree to.”

Traditional financial reporting in no way reveals the separate profit and losses for several reasons. First, it examines and reports department level expenses but not the work efforts within a department. Secondly, the non-direct product and non-base-service costs are only allocated (which is a dirty word to ABC/M) to products or base services; these costs are rarely isolated and directly charged to specific customer segments causing these costs. In financial accounting terms, the costs for selling, advertising, marketing, logistics, warehousing, and distribution are immediately charged to the “time period” in which they occur. Consequently the accountants are not tasked to trace the costs to channels or customer segments. Today's selling, merchandising, and distribution costs are sizable –

it now costs more for General Motors to sell cars than to make them!

As evidence, a high-tech semiconductor manufacturer performed ABC/M and discovered they were making roughly 90% of their profits from 10% of their customers. That alone is not unusual, but they were losing money on half of their customers. Upon discovering this, the manufacturer explained to some of its unprofitable customers how they could alter their own behavior to lessen the workload on the manufacturer so that a fair profit could be attained. The remaining unprofitable customers were “fired” – they were asked to take their business elsewhere, as there was little hope the sales would cover their costs. This manufacturer's sales levels then predictably dipped, but profits tripled. The lesson is the “quality of profit” associated with sales volume and product mix; there should be a focus on the customer contribution margin devoid of simplistic cost allocations similar to the current focus of cost accounting on product profit margins.

### Structural Deficiencies with Traditional Financial Accounting

The fact is behavior of customers and suppliers themselves are the source of a much greater amount of work-creation than most people imagine. For wholesalers and distributors, one can argue that customers cause almost all of the work. But even once that is understood, traditional accounting systems are ill-equipped to trace the costs. What is needed is to accumulate the costs of the various support work activities for the order-fulfillment work, and then to re-assign this order-fulfillment work into the product and customers who cause work to happen in varying amounts – and in proportion to their use. Traditional financial accounting systems are structurally unable to accomplish this.

Why? Traditional accounting only reports employee-related salary and fringe benefit costs – which reveal no insights to the content of work performed by employees – and that workload may be controllable. Traditional accounting also groups

### ABC is a Cost Re-Assignment Network

In complex, support-intensive organizations, there can be a substantial chain of support activities prior to, and upstream from, the work activities that eventually trace into the final cost objects. These chains result in activity-to-activity assignments, and they rely on intermediate activity drivers in the same way that final cost objects rely on activity drivers to re-assign costs into them based on their diversity and variation.

The direct costing of indirect costs is no longer an insurmountable problem, given the entry of computerized ABC software that evolved in the early 1990s. ABC/M allows for assigning intermediate direct costs to a local process output or to an internal customer or required component material that is causing the demand for that work. That is, the design of the ABC cost flowing assignment network no longer has to “hit the wall” from limited spreadsheet software and its restricted columns-to-rows math. The new generation of ABC/M software is arterial in design. Eventually, via this cost assignment and tracing network, ABC/M re-assigns 100% of the costs into the final products, service lines, customers, and business sustaining costs.

Let’s review the cost assignment network in Figure 1.0, beginning where customers (or beneficiary receivers) initiate the demands on work that ultimately require resources to be consumed.

Starting at the bottom module, all organizations have customers that behave as final cost objects; this existence ultimately creates the need for a cost structure in the first place. For example, customers purchase varying quantities or amounts of the organization’s products or service lines. As noted earlier, in some unique cases,

### The Traditional Profit and Loss Statement will be replaced by an ABC P & L with its “layered” Gross Profit Margins

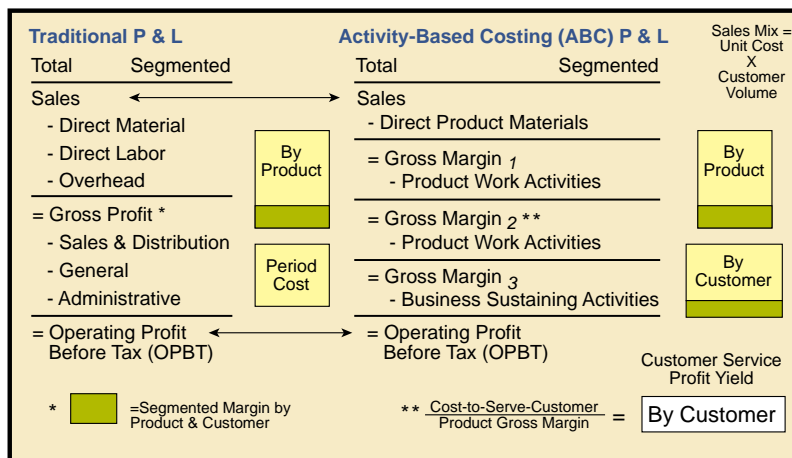


Figure 3.0 ABC P&L margin layers

costs according to the hierarchical and vertical appearance of the organization chart, denying any view of the true end-to-end business processes that start and finish with customers. Business processes are unaware of artificial organizational boundaries.

In contrast, ABC/M flexibly defines and measures costs at the level of work activities, regardless of function. Revisit Figure 1.0. The unique work activity costs caused by one’s suppliers, such as processing their purchase orders or negotiating deals, are burdened by those products that are purchased. The National Association of Purchasing Management (NAPM) refers to this as the “total cost of ownership (TCO);” this means the invoice price of the purchase does not reflect the entire cost of procuring that product. Just think about the differences between technically sophisticated suppliers who use EDI and bar-coding and archaic suppliers who use error-causing faxes. Which type of supplier causes more of your workload and costs – apart from the direct material purchase cost? Suppliers cause you different workloads independent of volume.

Calculating costs with ABC/M then allows re-assembly and assignment-tracing for all the work activity costs to reflect how each customer, channel and market segment consume the costs to get served.

With activity-based costing, the traditional profit and loss statement changes and becomes like the layers of an onion-skin. Figure 3.0 contrasts the traditional P&L with an ABC P&L. It shows a simple report revealing varying margin layers. The left side of the figure shows what most managers see today. Only the products are costed (and the product overhead costs are themselves frequently mis-allocated to the products). The right side ABC P&L shows that first, exclusively product-related margins can be viewed, and without the misleading distortions from overhead cost mis-allocations (traditional overhead cost allocations apply volume-based factors without correlation, and not use-based activity drivers that possess cause-and-effect relationships). Then, as customers consume (i.e., purchase) their unique quantities of the mix of products, where some products may be stand-alone profitable and some not at the product level, then the “cost-to-serve” customer-related costs are combined to calculate the next profit contribution margin layer.

### ABC/M Contribution Layering

A true ABC/M system operates as a re-assignment system. Let’s revisit Figure 1.0. Figure 1.0 reveals how the costs flow

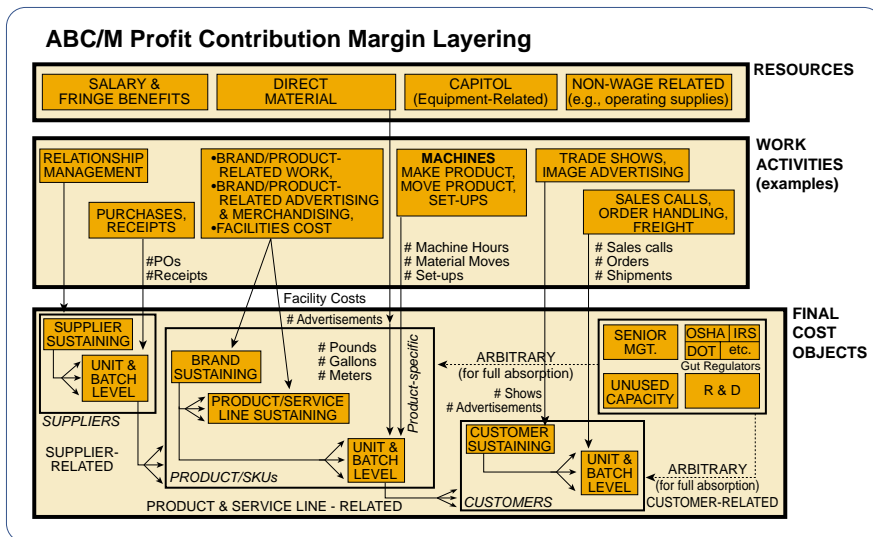


Figure 4.0 ABC/M Profit Contribution Margin Layering

through the cost assignment network.

One of the insights gained from ABC/M is an understanding of how final cost objects, such as suppliers, products, channels, and customers, vary with the work-related activities that they consume. Some activities, such as opening a new customer's account or placing a product into a box, vary directly with each specific supplier, customer or product (i.e., cost object) processed or serviced. These are called unit-level costs. Workloads vary directly with each unit of output.

There are other activities, such as changing over machine settings in order to make different products, for which the time or work effort varies independently of the batch size (i.e., the quantity of the machine run volume). These kinds of work activities vary directly with each event when the machine is re-set. Another example, customer-related, is where the length of time processing a customer invoice is independent of the price of the invoice. These are referred to as batch-level costs.

Both unit-level and batch-level costs can be attributed to specific suppliers, products, or customers without debate since the products or customers are the final cost objects causing and consuming the work. There is a third higher level activity cost type referred to as "sustaining" costs. Sustaining costs can be applied to the

business as a whole, or to customers, products, or suppliers.

Figure 4.0 expands on the ABC/M cost assignment network's final cost object module. It displays two layers of "nested" consumption sequence of costs. A metaphor for this consumption sequence is the predator food chain from the animal kingdom, where large mammals eat smaller mammals who eat plants. The final-final cost object, which in this figure is the customer, ultimately consumes all of the costs, except for the business sustaining costs.

Within each of the major final cost object categories (suppliers, product/service line, and customers), they each have their own "sustaining costs" which are assignable to their end-product or end-customer. However, when tracing these "sustaining costs," they can not apply a measurable quantity volume as applied by the batch-level and unit-level activity costs. For example, a branding program may benefit a select group of products, for which those products can be specified, but how much of the branding cost to each product? These "product sustaining costs" can be traced using some "shared" basis, such as sales unit-volume or spread evenly, even though there is no cause-and-effect.

In short, sustaining costs can be assigned to products or to customers using what may appear as the old flaws of cost

different suppliers create differing demands on work for similar products, so the suppliers may also be segmented to reflect their variation. Note that the supplier's total product or service line costs, although they may be identically priced as those of an alternative supplier, would now reflect different costs reflecting the varying ease or difficulty working with that supplier.

It is in this final cost object module where diversity is most apparent and into which all upstream activity costs flow.

Next, skipping past the middle module (i.e., activity costs) and moving up to the top module, the traditional general ledger expense balances are displayed. The cost assignment diagram in Figure 1.0 only reveals assignment paths from the payroll-related costs; but paths for the non-payroll expenses, such as supplies and operating expenses, exist for any organization. These paths are simply not shown to reduce the complexity of Figure 1.0, but all of the non-payroll related resource costs also flow through the cost assignment network. Payroll-related costs are very important to ABC because they are the more controllable expenses. The activities performed by workers who use those resource costs "drag" along and consume many of the other non-payroll resource costs such as supplies. (Figure 1.0 traces the ledger expense balances into a "staging" account of work groups, which in turn are re-assigned to the work activity costs using resource drivers, such as timesheets.)

The most important ABC module is arguably the middle one – the activity module. This module is not only where the work activity costs are initially costed, but then they are further re-assigned to the supplier, product, service line, channel, customer or

business sustaining final cost objects – those objects that collectively create demands on the organization's work. Unfortunately, for many organizations, after they have expended the effort to define their work activities and calculate their activity costs, they stop. Activity costs are actually the starting point of both ABC and ABM, not the end!

### Business Sustaining Costs

Business sustaining costs are those costs not caused by products or customer service needs. The consumption of these costs can not be logically traced to products or customers. One example is the accounting department closing the books each month. How can we measure which product caused more or less of that work? We can't.

Another example is lawn maintenance. Which customers or products cause the grass to grow? These kinds of activity cost can not be directly charged to a customer, product or service in any equitable way; there is simply no "use-based" causality originating from the product or customer. The need to recover these costs via pricing or funding is eventually required, but that is not the issue here; the issue is fairly charging cost objects when no causal relationship exists.

Business sustaining costs (or organization sustaining for governments and not-for-profit organizations) can eventually be "fully absorbed" into products or customers, but such a cost allocation is arbitrary. There is no cause-and-effect relationship between a business sustaining cost object and the other final cost objects. When these costs are assigned into final cost objects, organizations often refer to them as a "management tax" representing a cost of doing business apart from the

## ABC/M PROFIT CONTRIBUTION MARGIN LAYERING (predator food chain)

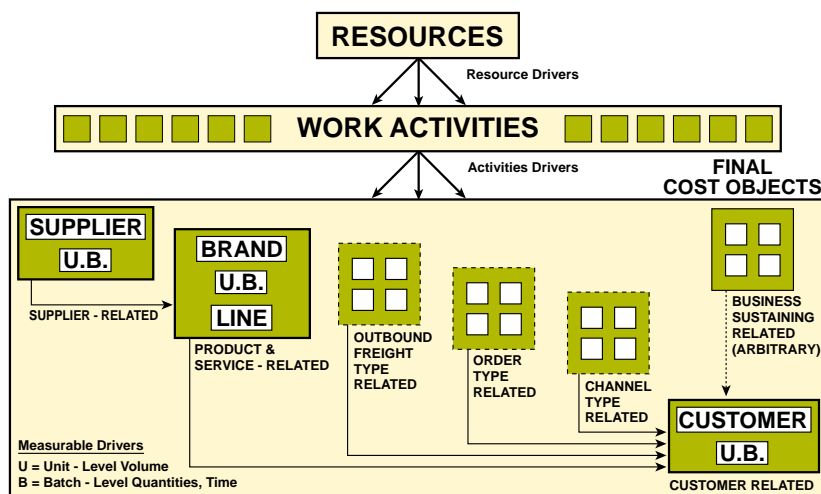


Figure 5.0 ABC/M Predator Food Chain

allocations. They capture the diversity of mix segments and isolate the sustaining costs to the type of final cost objects that cause the activity costs, usually to a subgroup within that final cost object.

### Additional Final Cost Object Types

In effect, what ABC/M does is reflect how the variation and diversity of cost objects segment activity costs and resource costs. If there are substantial costs and sufficient diversity in another type of cost object, for example, the type of customer order (standard, special, adjusted, international, etc.), then the "order type" can qualify as its own separate and visible final cost object. Another example might be type of freight-haul trip, such as truck, marine, or rail, or as less-than-truck load (LTL) versus full truck load. This type of receiving final cost object would serve as an intermediate repository to capture diversity of the type of work output. After activity costs are traced to these final cost objects, then those costs are re-traced to the customers based on the mix of order-types consumed by each customer. Hence, "all customers are not created equal." ABC/M equitably traced

all the costs based on unique usage.

Figure 5.0 displays three potential cost object types that could be isolated and assigned to an intermediate destination for activity cost accumulation prior to being re-assigned to customers.

Note that without being isolated, these activity costs would have been directly assigned to customers from the same activity costs. But by isolating them, via a two-step cost assignment method, the activity costs are initially grouped the way they match the workload, and then the customer is shown to be "purchasing" the output. The second of the cost assignments is referred to using ABC/M lingo as cost object drivers (the term "activity driver" is no longer applicable as the work activity already accumulated in the final cost object.)

For advanced ABC/M users, they may wish to view product profitability including customer costs (e.g., to determine and print prices in their price list catalog). Today's advanced ABC/M software allows multidimensional views of various combinations of cost objects. A two-way bi-directional linkage replaces the sequence of the predator food chain. Other dimensions can

## ABC/M CUSTOMER PROFIT & LOSS STATEMENT

CUSTOMER: XYZ CORPORATION (CUSTOMER #1270)

SALES	\$\$\$	Margin \$ (Sales - Costs)	Margin (% of Sales)
<b>Product-Related</b>			
Supplier-Related Costs	\$ xxx	\$ xxx	98%
Direct Material	\$ xxx	\$ xxx	50%
Brand Sustaining	\$ xxx	\$ xxx	48%
Product Sustaining	\$ xxx	\$ xxx	46%
Unit-Batch	\$ xxx	\$ xxx	30%
<b>Distribution-Related</b>			
Outbound Freight Type*	\$ xxx	\$ xxx	28%
Order Type*	\$ xxx	\$ xxx	26%
Channel Type*	\$ xxx	\$ xxx	24%
<b>Customer-Related</b>			
Customer-Sustaining	\$ xxx	\$ xxx	22%
Unit-Batch*	\$ xxx	\$ xxx	10%
<b>Business-Sustaining</b>	\$ xxx	\$ xxx	8%
			<b>8% Operating Profit</b>
<b>Capital Charge** (inventories, receivables)</b>	\$ xxx	\$ xxx	2%
			<b>6% Economic Profit (for EVA)</b>

\* Activity Cost Driver Assignments use measurable quantity volume of Activity Output (Other Activity Assignments trace based on informed (subjective) %s) \*\* Capital charges can also be directly charged as imputed interest to products & cust.

Figure 6.0 3-D ABC/M Profit Contribution Cube

include geographical sales territories, store locations, or specific salespeople.

### The ABC/M Customer Profit and Loss Statement

As costs flow from one final cost object to another final cost object, each flow will consume the unique mix of the upstream cost object. In simpler terms, an individual customer's total costs (apart from its direct costs-to-serve) are inclusive of only the product quantities and mix that he or she purchased. Furthermore, each product incurred its own activity costs with a cause-and-effect relationship, not with an arbitrary indirect cost allocation.

Figure 6.0 reveals the "layering" of costs similar to Figure 3.0, but in the shape of a 3-D cube. The costs for each successive step along the "predator food chain of costs" are inclusive of only the unique mix of costs that were purchased or consumed. ABC/M's "drivers" always provide the assignment bridge into the next successive level that consumes the upstream costs.

Figure 7.0 is an example of an individual customer profitability statement. Using ABC/M, there can now be a valid P&L statement for each customer, as well as logical segments or groupings of customers. There can be a tremendous amount of detail below each of these reports. For

example, the individual products and service lines purchased can be examined as they are a mix of high and low margin on their own. Within each product or service line, the user can further drill down to examine the content and cost of the work activities and materials ("the bill of costs") for each product and service line. ABC/M users refer to this data mining and navigating as "multi-dimensional reporting;" they use "online analytical processing (OLAP)" tools for viewing the output of the ABC/M calculation engine. This is powerful information. The sum of all of the customer profit and loss statements for this type of report will add to the entire business' enterprise-wide profit (or loss). That is, it reconciles with the company's official books – the bottom line.

### Revelations From the New Cost Data

Note that back in Figure 3.0 the three margin levels do not include any "business sustaining expenses," the company internal tax, which were not caused by suppliers, products, base-services or customers. It is true that these expenses must some way be eventually recovered in total via pricing to be overall profitable, but an ABC/M profit and loss statement reveals that they do not necessarily have to be recovered by all

products and services.

Examples of final cost objects that comprise business sustaining cost objects may include: senior management (at individual levels, such as corporate, division, and local) or government regulatory agencies (such as environmental, departments of transportation, occupational safety, or tax authorities). In effect, these organizations, via their policies and compliance requirements, or via their informal desires such as briefings or forecasts, place demands on work activities that are not caused by or attributable to specific products or customers.

Other categories of expenses that may be included as business sustaining costs are idle capacity costs or research and development (R&D). R&D costs might be optionally assigned so that the timing of the recognition of expenses is reasonably matched with revenue recognition for sales of the products or service lines. However, remember that ABC is managerial accounting, not regulated financial reporting, so strict rules of accounting principles (GAAP) need not be followed, but can be borrowed.

products and by all customers.

This revelation can give progressive and innovative companies tremendous flexibility to price low for emerging products and for targeted new customer prospects, and to price higher with more loyal and secure customers less likely to switch to competitors. However, if too often or too many prices are set slightly above the "marginal costs," as time passes where products are phased out and customers depart, then the profit structure risks being slowly replaced without enough sales recovering the business sustaining costs. So this practice must be carefully managed. For example, low prices to capture new customers will need to be gradually increased over time.

The ratios of the "costs-to-serve-cus-

tomers” to the product mix margin are revealing when compared on a customer-by-customer basis (or by segment or channel). A traditional belief that large volume customers produce proportionately large profits may be dispelled. Companies using ABC often discover that if given an extra hundred dollars to “serve” a customer, it would return a relatively higher profit contribution from mid-size or smaller customers.

### Migrating Customers to Higher Profitability

Figure 8.0 provides a two-axis view of customers with regards to the “composite margin” of what each purchases (reflecting net prices to them) and their “cost-to-serve.” Each quadrant of the matrix shows a different type of customer. Figure 8.0 debunks the myth that companies with the highest sales must also generate the highest profits. This is not necessarily true!

Figure 9.0 shows various customers as points of an intersection of Figure 8.0’s matrix. The objective is to make all customers more profitable – represented by driving them to the upper-left corner. This can be accomplished by: (1) managing their “cost-to-serve” to a lower level, (2) reducing their services, or (3) raising prices or shifting the customers purchase mix toward richer, higher-margin products and service lines. (Note that migrating customers to the upper-left corner is equivalent to moving individual data points from right to left in Figure 2.0.)

Knowing where customers are located on the matrix requires ABC/M data.

### Intra- Versus Inter-Organizational Costing

Supply Chain Management is forcing all participants in the value chain to want to know what the costs and profit margins are for the all of their upstream and downstream trading partners. Many hold the misconception that the only view for this information would be a cumulative time-flow chart starting with Mother Earth’s minerals and resources and ending at the retail store’s shelf. Figure 10.0 shows the problem. Each trading partner cannot see the true costs up to their point in the chain; they are blocked

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Figure 7.0 ABC/M Customer P&L Statement

### ABC/M CUSTOMER PROFITABILITY MATRIX

Customers with high sales volume are not necessarily highly profitable. Customer profitability levels depend on whether the net revenues recover the customer-specific cost-to-serve.

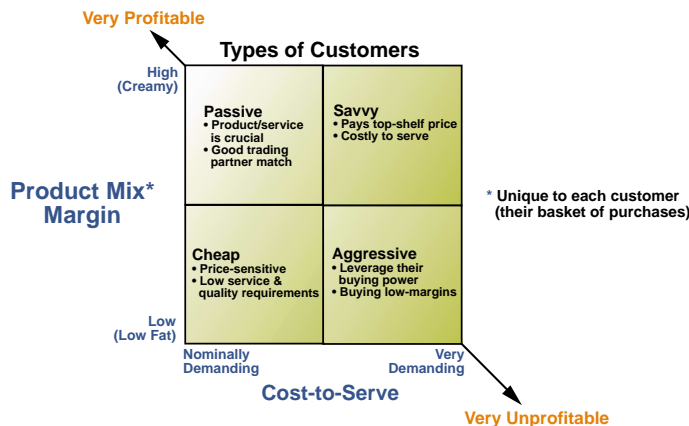


Figure 8.0 ABC/M Customer Profitability Matrix

and shielded not only by their direct supplier’s price, but also the “cost shields” of their supplier’s suppliers.

If one of the suppliers in a supply chain is benefiting from obscenely high profits, how do any of the trading partners know? Let’s imagine a change where that particular supplier reduced its price, and that price reduction passed through the chain to the end-consumer. This would sales raise volume for every partner in the entire value chain. In fact, the lower-tier supplier’s prof-

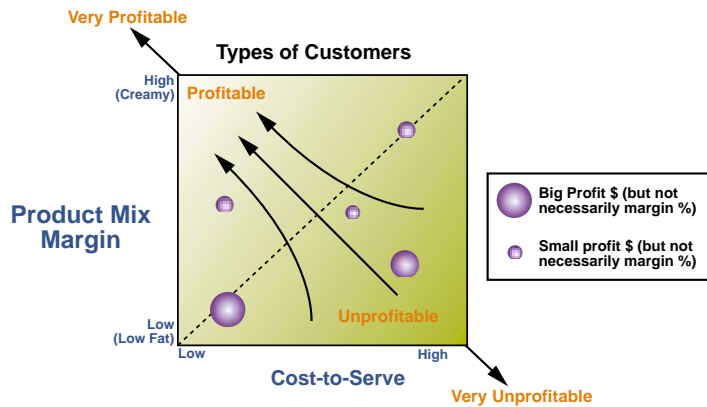
its might incrementally become relatively higher than before because of that price reduction – and that is certainly true for every other trading partner.

In order for the entire supply chain to effectively perform margin management, it must be able to have some form of “open book” visibility to the supplier’s product-specific costs. Today, each buyer can already see the invoice or catalogue-listed price of their suppliers’ products as well as those of their suppliers’ suppliers – but no one can



### ABC/M CUSTOMER PROFITABILITY MATRIX

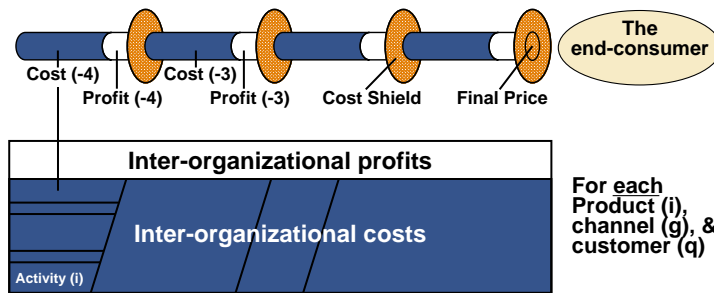
Knowing where channels or customers are located requires knowing their true costs via ABC.



With the facts, customers than be migrated toward higher profitability by: (1) managing the service costs, (2) reducing their services, (3) renegotiating prices and or shifting their purchase mix to richer products

Figure 9.0 ABC/M Customer Profitability Matrix

### INTER-ORGANIZATIONAL COST AND PROFIT BLINDNESS



The only way that buyers and sellers along the Supply Chain can meaningfully discuss opportunities, is if each trading partner has activity-based cost management (ABC/M).

Figure 10.0 Migrating Customers to Higher Profitability

see the profit margins specific to each product and to each customer!

The only way to have view of these costs will be through open-book collaboration and trust. And since the only relevant costs to a buyer are those specific products and services that he or she is procuring, then each supplier requires a strong cost system. This means that each supplier needs a reasonably accurate cost assignment system with “bill of activity” cost visibility. The visibility of work activity costs – segmented

by product, by service, and by customer – enables mutual and intelligent discussions among the trading partners as to where to remove waste and redundancies or to shift functional skills and tasks amongst the participants in the value chain. The sad truth is, many of the trading partners have archaic and poor product cost allocation practices and no repeatable or reliable cost assignment methods for distribution, sales, and customer management.

With most suppliers, Newton’s Third

Law of Cost Accounting applies: “For every freeloader, there is an equal and opposite sucker.” That is, even if suppliers disclose their specific product and service costs, from which profit margins can be derived, the calculated costs are likely to be bogus, or at least have uncertain error. This means that all the suppliers’ products are probably over- and under-costed. Until the supply chain applies some forms of activity-based methods for absorption and direct costing, then the supply chain participants will be weakened from making insufficiently informed decisions. Inter-organizational costing will remain a dream.

### Beware the Learning Organization

As progressive organizations – and some may be your competitors and your suppliers – gain proficiency and mastery with the business intelligence provided by ABC/M, they can be formidable. What those companies are recognizing is that each individual customer affects the profitability of their brand products, base services, and market segments. The effect is due to the customer’s purchasing habits, delivery location, discount/rebate structures, or other diverse ways it places demands on its suppliers. When equipped with ABC/M’s superior data, your competitors can “cherry-pick” the premium-profit customers, strategically price for new product entry, and even send “false signals” with price quotes deliberately set at levels to lose the business so that their competitors will not suspect they have a far more accurate quoting engine.

Future competitive differentiation will be based on the speed rate at which organizations learn, not just the amount they learn. Your organization should understand and master ABC/M as the route to understanding your customer profitability, and your trading partners should not be blind to where they make or lose money.

Having the visibility to all of this cost and margin data is a beginning. People must act and make decisions with this data. But in the land of the blind, the one-eyed man is king