# Making Money the Old Fashioned Way Calls for New Thinking

*A Closer Look at Customer-Product Rationalization*

The dynamics of today's markets coupled with the pressures to compete, requires that each of your company's products and customers contribute to overall profitability. The truth is that few companies have the insights required to distinguish financially good products from bad, and the most valued customers from those that strain the corporate coffers. Traditional methods for capturing these insights are frequently misleading. Taking off the corporate blinders on this fundamental area is a critical step toward managing company profitability in today's demanding financial climate. Customer-Product Rationalization™ is a technique for providing the required insights for management who are ready to act.

**The Dangers of Traditional Thinking**

Does your company make money on each of its products? Are every one of your customers profitable? If you could reduce the number of product options you now sell, what would be the impact on your bottom line? If adding that next great product necessitates dropping an existing product from your line, which would it be? How do you develop an unbiased case to make these decisions? And when you send in your profitability improvement teams, where do they look first?

For many companies today the 80/20 rule is all too real when the subject turns to customers, products and profitability. Our observations show that it is not unusual to find companies with product lines ranging from dozens to thousands of individual SKU's where fully 80 percent are either profit neutral or negative. Not that reported company data indicates this, but it becomes apparent once the true costs are known. One implication is obvious: a large share of existing products – and by extension, customers – represent drains on company profitability. Further, if these profit pariahs are either resuscitated or eliminated, your company could reap a significant windfall, not only now, but in the future as well.

But even more serious implications lurk just beneath the surface. The company's financial health may be far more tenuous than once believed, tied not to a diversified portfolio of products, but to surprisingly few – and to the customers who purchase them. Also, somewhat paradoxically, is the notion that efforts to increase the sales of these "losers" might actually decrease profitability rather than increase it. And possibly the most disturbing fact: Based on the information typically available to company decision makers, any (and all) of these factors may exist today without management's knowledge. *And even if they knew, how would they begin to address the challenge?*

**The Challenge**

Why do so many companies find themselves in this seemingly paradoxical situation of apparent product abundance with singular dependency? The typical reasons are several.

Product proliferation**.** Successful companies are often associated with robust product lines that offer "something for everyone," from Baskin Robins 31 flavors of ice cream to Heinz 57 varieties. The drivers include the appeal of one-stop shopping for customers, the goal to widen the target market and the accompanying revenue, and the opportunity to up-sell and cross-sell customers with new or different products within the same branded family. This last goal approaches profit nirvana, where revenues increase with little in the way of additional selling costs.

Product inertia. Many companies have robust product lines that have evolved over time, but surprisingly few can point to adequate mechanisms for handling systematic product life cycle management. Once introduced, product retention becomes a *fait accompli* with forces in place to help ensure that individual products survive no matter what the cost to the company. Existing customers are one source of this inertia, but so are sales teams, production staff and management. All of these players have a stake in maintaining the status quo for existing products.

Product identity. Some firm's identities become inextricably linked to specific products, whether they continue to contribute to profitability or not. While this brand tie-in can be beneficial when

the company is just starting out, over time as the market changes, product identity can become an albatross to corporate vibrancy and bottom-line return. Its no wonder why companies as well-known as IBM, NCR, NL Industries and 3M decided to opt for their initials, rather than their original corporate names which speak to products of an earlier era. And it's also clear that many of yesterday's "star corporations" have lost their brilliance due to anemic product life-cycle management.

**The Complication**

Many companies look to traditional cost accounting methods as a way out of this product-valuation dilemma. The theory is that by understanding the true product costs, they can be valued against the revenues they produce as a measure of marginal product profitability.

And traditional cost accounting does indeed allocate indirect costs to products in an effort to derive their true costs of manufacture and support. However, lacking the ability to tie overheads directly, cost accounting methods often fall short. They typically rely on metrics, such as labor or equipment hours, associated with the product volume as the basis for this allocation. While common in practice, these allocations can oversimplify the product-cost relationship, distorting actual costs and obscuring product-specific decision making, making the approach far less ideal.

For example, in a business with a mix of product types, high-volume/low-complexity products will receive a disproportionately large share of the allocated costs, while low-volume/high-complexity products escape their rightful overhead burden. The result is to make the lowest volume products appear excessively profitable, or worse, to drive pricing levels insufficient to adequately cover true costs of production. In a similar analysis, cost accounting approaches can make small lot sizes appear overly economical, masking the true costs associated with production line change-overs, recalibration of equipment and scrap.

Alternatively, the Activity Based Costing technique, or ABC, matches indirect costs and overhead to products directly, overcoming allocation issues, but at the expense of additional data collection and analysis. In cases where traditional cost accounting cannot be relied upon to represent the actual product costs, ABC is frequently more reliable. The complication faced by all ABC methods is the added costs and complexities required to extract and maintain the essential cost data, not a trivial issue in today's dynamic, networked production environment. And when the issue of customer-product relationships is introduced, the answer is no longer "as simple as ABC."

**CPR**

*So what does a forward-thinking company do?* Combating the triple threats of product proliferation, product inertia and product identity is achievable through a program of investigation, assessment and action. We call such a program Customer/Product Rationalization, or simply, CPR. CPR is a proven methodology that offers visibility to the true costs of providing each product and serving each customer, making it clear which products are profitable, and more importantly, which are not. These new insights permit a rational approach to retention, remediation, replacement or retirement of specific products or product lines. At the same time impacts on the customer base and profitability are taken into consideration.

Retention. Able to associate true costs with individual products and associated customers, the CPR methodology provides the business-case rationale and quantitative basis required to justify product retention. At the same time, CPR analysis can contribute significantly to the company's strategy on the product's future. Following CPR analysis there is an improved understanding of what products mean to the business in individual financial terms, and relative to one another. "Retained products" can be categorized by revenue impact, margin effect, working capital requirements and dependencies – on the corporate asset base, external suppliers and specific customers, markets or geographies. With CPR the stage is set for target performance and incremental improvements in measurable terms, making even the strongest products even stronger.

Remediation. Product remediation is a provisional status that reflects the need for additional attention to some component of a product's profit contribution. Following the appropriate action and achievement of the desired results, these products will be reclassified for "retention" under the guidelines of the

product lifecycle program. In cases where remediation fails, products are relegated to replacement or retirement status.

Retirement. Product retirement is a vastly underused option within the product life cycle. It reflects the realization that over time most markets change, or are served by new alternatives, that are in some ways preferred by the customer base. Lower cost materials, better technology and improved production processes are just some of the drivers for retirement, as are fashion, economic health and government regulation. CPR helps, not only in identifying candidates for retirement, but also in the associated costs and benefits of removing these products from the active product slate. Since retirement is often final, companies taking this route need to understand the full long-term impact and CPR is just the ticket.

Replacement. Product replacement is a hybrid joining the attributes of product retirement and retention. Initially, CPR identifies the candidates for product replacement. It then goes further to provide management with the insights needed to decide whether, when and in what way replacement should be conducted to minimize both customer and company impact. The flexibility inherent in the CPR methodology allows development of various case alternatives and sensitivity analysis, tuned for rapid implementation.

**The New Rules of (Profitable) Business**

What's the Catch? At its best CPR implies new business rules that influence how business is done. Firstly, business is viewed as profitable, only if the selling price exceeds the "cost to serve." This means not simply covering the raw materials and direct manufacturing costs, but the indirect costs as well. And it includes the cost of extra services and discounts, such as those that are provided as enticements to win the business.

Secondly, service levels are apportioned to customers based on both customer and product value with careful delineation made to ensure that the best customers are served best. This requires knowing customer and product values as service strategies are formulated, then supporting and measuring the follow-through. Ultimately, companies want to ensure that every customer is profitable in the long run and that can be done only by design. Customer profitability must be managed explicitly.

Finally, product production needs to be targeted and incented to support the most profitable business, not just any business. For many company's this represents a major mindset change: allowing customer profitability to drive decision-making, not aggregate throughput or production-line utilization. These volume-related considerations are important to be sure, but under CPR analysis, other dimensions of the cost to serve are given similar stature when making production decisions.

In summary, unlike traditional cost accounting, CPR investigates the actual linkage of indirect costs to the products produced and the customers who buy them. In this way CPR avoids the top-down generalizations that weaken common accounting methods. And different from Activity Based Costing, CPR uses an investigative approach that gets quickly to the heart of true cost assignment, providing an 80/20 assessment that is available in weeks or months, rather than the much longer time-to-result often necessary with ABC. And like most diagnostic tools CPR can be readily tailored to the unique characteristics of the business under study, responsive to management goals, the dynamics of the marketplace, and the resources available to fund the work.

**About Osti & Associates**

Osti & Associates is a management-consulting firm that works with senior executives and management teams to deliver breakthrough business solutions. We apply our unique blend of creative problem solving and deep analytics to compelling challenges including business strategy, process improvement, and product line optimization.

Osti & Associates has developed it's proprietary CPR Fast Diagnosic that quickly accesses the improvement opportunity and identifies key areas to focus upon for delivering results. Please visit www.ostiassociates.com/cpr.html for more information or contact us at info@ostiassociates.com.

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