



Uncovering Pockets of Profitability from your Accounting Data

Using Tax Prep as an Opportunity for Growth

Summary: Don't put those tax files away! For many small business owners tax preparation may be viewed as an undesirable (yet necessary) expenditure of time and money. This month's ToolKit focuses on transforming tax preparation into an opportunity for increasing profits. Here we will help you think about restructuring your accounting data so you can easily and systematically track profits by customer, products, and services. The Pockets of Profitability worksheet can be handed to your accountant or financial manager to leverage your existing accounting system into a full-fledged customer and business knowledge center.

The State of Accounting Avoidance

What are your feelings when you need to work with your accounting system? Fear? Confusion? Dread? Disinterest?

As a result most small business owners invest as little time, money and thought as possible into the accounting function. Off-the-shelf software is used "as-is", with no customization for the particulars of your business. The only data collected is that required for tax reporting. Moreover, basic financial reports, like Company level profit and loss statements, are generated on a sporadic basis. Usually this data is "stale" (3-4 weeks old) by the time the owner has time to review the information. Unfortunately, this general, out-of-date information is used as a basis for making important growth decisions, like the hiring or letting go of staff, or the decision to add or cut product/service lines.

Think of your Accounting System as a Knowledge Gold Mine - rather than an Administrative Pit

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" (aka areas where you should focus your growth efforts). Properly structuring your accounting & 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?

Five Simple Steps to Create an Accounting Knowledge center

In this tough economic environment, the answers to these questions may save you money, or even the future of your business. **Studies indicate over 50% of customers do NOT generate sufficient profits to sustain operations.** That means that the sooner you can shed these unprofitable customers, products or services, the sooner you will save valuable money and effort.

So before putting away your tax information, follow these steps with the Pockets of Profitability worksheet (found at the end of this article):

1. Use Accounting History to Create Meaningful Customer Groups.
2. Start rating and tracking your marketing efforts and customer loyalty.
3. Decide on Product and/or Service Groupings.
4. Assign direct costs to customers and jobs to track profitability.
5. Use Customer, Product or Service Level Financial Reports To Focus On Pockets of Profitability.

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 will 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)



- 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 give to 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 now 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 & benchmarks on a periodic basis throughout the year.

Exploiting Your Pockets of Profitability

Fill out your decisions in the Pockets of Profitability Worksheet 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. Banks and 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.

Please share your stories and insights either via [email](#) or on our [blog](#). Your feedback is what helps make the RoadMap Marketing Toolkit real and relevant.

Author's acknowledgement: The insights and process for this article were taken from years of collaborative work with Sandi Chaisson, Your CFO on the Go® (www.YourCFOontheGo.com). Sandi creates value for her small business clients by elevating financial data into a strategic asset that drives profitable growth. Sandi has taught me a great deal about the value of accounting data, the basis for this month's Toolkit.

Pockets of Profitability Worksheet 5 Steps

1. Use Accounting History to Create Meaningful Customer Groups.

Create a list of past customers and also past proposals (even if unsuccessful). Group these companies by categories that are meaningful to your sales and marketing efforts. (See article for examples to guide your thinking.) Select 1-3 categories; rank them from most important to sub-segment.

- Customer Category (top) Level 1 _____
- Customer Category (sub) Level 2 _____ (optional)
- Customer Category (sub) Level 3 _____ (optional)

Creating Customer Groups in QuickBooks:

Under "List" Pull down menu

- Select "Customer & Vendor Profile Lists"
- Select "Customer Type List"
- Enter 1st segmentation category
- Enter 2nd segmentation category as a subtype of the 1st category
- Repeat until all segmentation categories are entered

2. Start rating and tracking your marketing efforts and customer loyalty.

Check the following classifications (or create some new ones) that you can use to track your marketing and sales effort:

- Source (or how you got this customer)
- Referral tracking (or number of leads referred by this client)
- Other _____

Editing Customer Profiles in QuickBooks:

- In the "Customer Center", select a customer to edit.
- Select "Additional Info Tab"
- Select "Type"
- Enter desired customer segmentation
- Repeat for all customers

3. Decide on Product and/or Service Groupings.

How do you bundle or present your products/services? List and give to your accountant.

4. Assign direct costs to customers and jobs to track profitability.

(Your accountant or financial advisor will do this.)

5. Use Customer, Product or Service Level Financial Reports To Focus On Pockets of Profitability such as Profit and Loss by Market Segment, Profit and Loss by Customer and Profit and Loss by Product/Service Group