

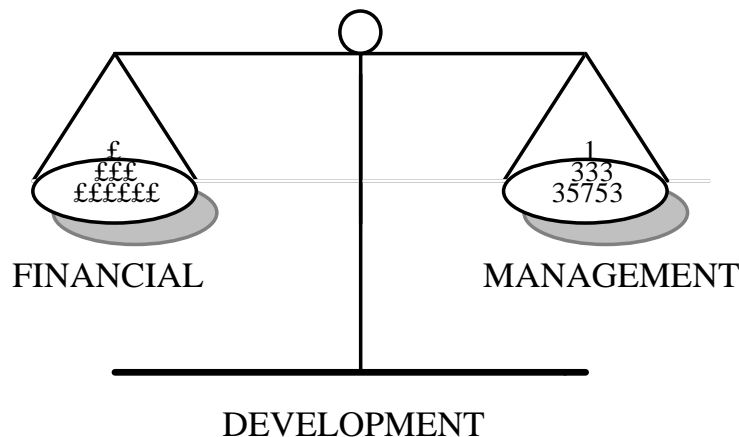
FINANCIAL MANAGEMENT DEVELOPMENT

Decision Making

Customer Management

NO 321

CUSTOMER RELATIONSHIPS



ONE OF A SERIES OF GUIDES FOR
FINANCIAL MANAGEMENT DEVELOPMENT

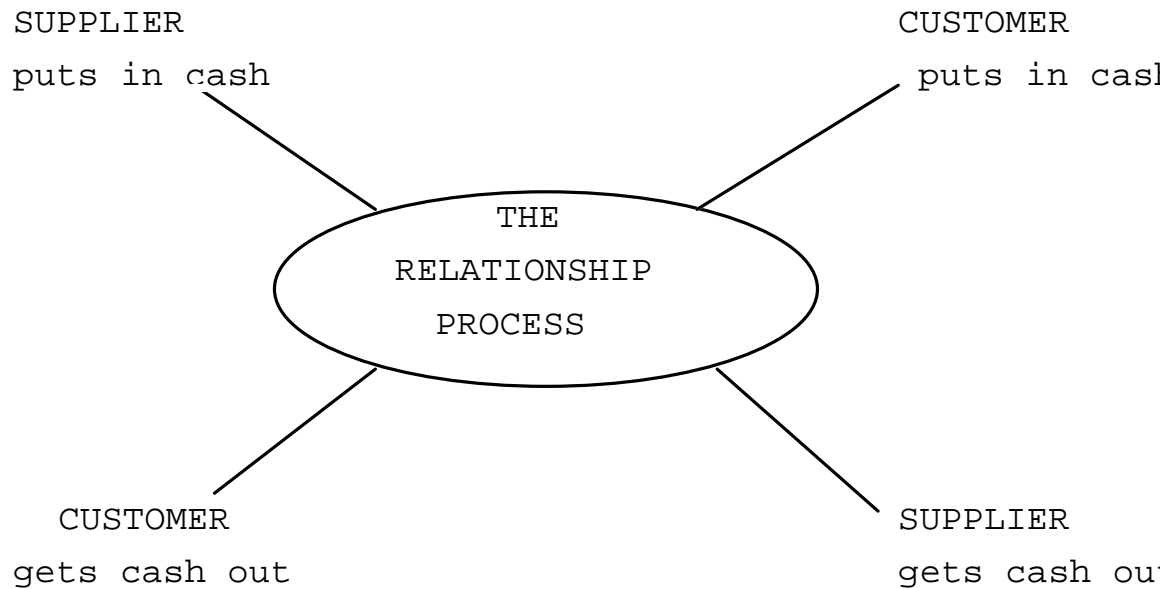
FROM

www.FinancialManagementDevelopment.com

This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

CUSTOMER RELATIONSHIPS

From a purely financial point of view a supplier-customer relationship can be represented as follows:



The intention is that for both parties the cash received will be greater than the cash put in. The relationship will therefore have added value. No one should feel uncomfortable about expressing everything in cash terms. Cash is merely a universal language which facilitates the comparison of values of different goods and services. It is no different from English. No one feels uncomfortable about using words to talk about concepts.

In essence, Businesses exist as a mechanism to part customers from cash in return for the provision of goods and services (if necessary), using the least investment of cash to do so.

Seven points need to be made:

1. OPPORTUNITY COST

The cash value includes all the costs and benefits of the relationship. Some of these are valued at opportunity cost. The supplier could allow use of an otherwise idle factory. This "costs" nothing. However the supplier may have to devote an account manager to the relationship. The cost of this is could be valued at the benefit lost by not using the account manager elsewhere, or the cost of acquiring a new account manager. It is important that the Opportunity cost is the cost of the next most

attractive alternative not some unattainable dream (e.g. the cost of the lost £1 million sale that the account manager might have made).

The same method applies to the cash valuation for the customer. In particular the value of the benefits is effectively the cost which would have had to have been paid for the services elsewhere or the value gained from using the services to generate cash from associated activities, whichever is the lower.

For both parties the costs must include all the costs of the relationship, both set up and ongoing. This may mean estimating values for the cost of invoice processing, payment handling, resolution of queries, even the emotional cost of dealing with someone you do not like. These may be difficult to quantify, but it is better to be approximately right than to be precisely wrong. They represent the true cost of doing business. Suppliers, customers and in another context managers, should be aware that a high price needs to be paid to compensate for unhappiness.

2. TIMING OF CASH FLOWS

It is essential that the cash values are expressed in net present value terms. A number of organisations ostensibly add value by returning cash in excess of that they have received, but in NPV terms they have not added value. There are also many organisations who make their money from the holding of customers' funds rather than the provision of goods and services. Agreement on timing and the contractual arrangements may be crucial to the agreement. There may be considerable "Profit" to be made from deals where cash is received in advance e.g. Phonecards, Stamps, Tokens, Deposits. It is up to each player to determine their own time value of cash, normally by considering a notional interest rate (effectively the opportunity cost of capital), and there can be win-win situations, otherwise banks would not exist.

3. TAXATION

In a normal commercial situation in the UK any "value added" by the process will be taxed at 17.5%. There may also be Excise Duties to consider, including the cost of funding them or the benefit from delayed payment. In addition the "profit" generated will be subject to taxation. Thus it is necessary for the relationship to take into account these cashflows and when and by whom they are paid.

It is unlikely that any Government will allow a scheme which works to its disadvantage to operate for long without taking retaliatory action.

4. SHARING

There is no logical reason why the benefit from the business relationship should be shared equally. Ethics are difficult to translate into cash but in the long term it is reasonable for the net total benefit to be shared in some manner which compensates both parties equitably, taking into account the relative degree of risk being undertaken by both parties. If this is not done, one party will begin to cost the alternatives and find a new partner. In this regard, knowledge of the real profit being made is vital. In many organisations the Pareto principle applies: 80% of the profit is made from 20% of the products/customers. Losing a major profit generating stream of business can be catastrophic.

5. ADDED VALUE MUST BE REAL

It is not good enough to believe there will be synergy. It is vital that from the outset there is a clear understanding by both parties that the relationship will add value. Nowhere is the absence of this approach more clearly demonstrated than in the acquisition process. In the thrill of the chase and the heat of the negotiation it is entirely possible for a deal to be struck that adds no value but shares it fairly between the two parties. The cost of the negotiation process must be considered, including the cost of delays and disruption on the underlying business. In many acquisition situations the post acquisition profits are lower than expected because management attention has been on the acquisition process, not the business. The resultant fall off in profits is known as post-acquisition droop, as the effects are felt gradually from a point a few months after the acquisition date.

6. NOTHING IS FREE

If you cannot see how the other party can benefit then beware. It is perfectly possible for someone to offer better than normal terms. Some of the best frauds are quite simple. "I will give you £10 value if you pay me £6" is a perfectly understandable concept if the offeror has no intention of delivering the £10 worth of value. In any business partnership unless you can see how the other party is making money you should beware. Have you understood the true deal? What are you paying and what are you committing to?

7. THE ORGANISATION MUST BE DEFINED

Organisations need to define what are real business activities i.e. actions which cause cash to enter or leave the defined entity, and ensure all personnel are focussed on those rather than on "taking in each others' washing", which may produce results but adds no value.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development.

He has worked as a Financial Controller and Company Secretary in the Finance Industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over thirty major organisations including Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, The Post Office, Rothmans and Zeneca. International training experience includes work in Denmark, Kenya and the Czech Republic for Unilever, in Dubai for Al Atheer, in Holland and the U.S. for Avecia and Zeneca and in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. A key output from the training is demonstrable use of the knowledge and skills acquired to enhance corporate profitability. In addition he has run courses in acquisition evaluation (The Economist, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). He has also developed material for delivery by in house personnel (Royal Mail, Lloyds Bowmaker and Conoco) and computer based training packages (The Post Office, Unilever and BP).

He is a prolific writer of case studies, role plays and course material, he has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants and the need for taxation awareness training for general managers.

He is married with one grown up daughter and his outside interests include being The Treasurer of the Hospice of St. Francis (Berkhamsted), and a member of the Catholic Alpha Training Team (Promoting the Alpha course on Basic Christianity). He was a Governor of Luton University for nine years and a school Governor for four years.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).