How to Apply the 80/20 Rule to Your Business

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Most Los Angeles and Southern California business owners and entrepreneurs are familiar with the 80/20 rule. Also known as the Pareto principle, this rule states that for many events, 80 percent of the results come from 20 percent of the participants.

This principle was originally identified by Vilfredo Pareto who was a 19th century economist in Italy. He determined that just 20 percent of Italy's population owned 80 percent of the land. Before this, Pareto noticed that 20 percent of his garden's pea pods contained 80 percent of all the peas in the garden.

The 80/20 Rule and Your Business

The 80/20 rule is commonly applied to business using the following observation: *80 percent of a company's profits come from 20 percent of its clients.* If this is true, then it would follow that it's very important to identify which 20 percent segment of your client base is contributing 80 percent of your profits. Then you can devise strategies designed to make sure your limited resources (in terms of both time and money) are used in a way that maximizes your relationships with and level of service delivered to the customers who are responsible for the bulk of your company's profits.

But how do you determine which 20 percent of your customers are delivering 80 percent of your profits? This requires that you perform a comprehensive profitability analysis on your entire customer base. Such an analysis will determine the total volume of sales generated by each customer and subtract the cost of sales, freight costs that are related to the sales, any returns and credits associated with the sales, and any other costs that you can attribute directly to sales made to each of your customers.

These costs represent the hard, objective data that needs to be analyzed in order to perform a thorough profitability analysis. However, there are other more subjective factors that should also be analyzed. These include things like:

1. **Customer payment habits —** Does the customer habitually pay late or take discounts they aren't entitled to? Such customers are costing you money even if you don't realize it.

2. **Customer complaints vs. satisfaction —** Is the customer always complaining about your products or services? This takes extra time on the part of your employees, thus reducing their productivity, and also damages employee morale.

3. **Customer attempts to obtain a lower price —** Is the customer constantly trying to get you to lower their prices? Even if you hold firm in your pricing, this can wear on your salespeople after awhile and hurt their morale.

4. **Customer requests for special treatment —** Does the customer routinely ask for things like expedited shipping, accelerated turnaround time or some other kind of special treatment? These things may cost you real money, or at least the opportunity to charge a premium for such extras.

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5. **Customer order frequency** — Does the customer order from you on a regular or irregular basis? Regular customers are usually more profitable than one-off or occasional customers.

It's not always easy to place a dollar figure on such subjective factors as these, but they should still be considered as you perform your profitability analysis.

Accessing Detailed Cost Information

Performing a thorough profitability analysis requires access to detailed cost information that not every small business has. Without this data, you may have to make educated guesses or assumptions, which can lead to inaccurate costing and profitability figures. This, in turn, will make it much more difficult to determine which 20 percent of your customers are really contributing 80 percent of your profits

This is where an outsourced CFO services provider can help. Such a provider can help you identify all of the various costs associated with each of your customers, including both hard and soft costs. There are often very important, but subtle, distinctions between customers and costs that can be hard to pin down — an outsourced CFO has experience in helping many companies like yours perform cost and profitability analyses.

There are many potential benefits to identifying the 20 percent of your customers who are contributing 80 percent of your profits. For example, you will have a better idea of where to deploy your limited resources for maximum return on investment. Also, you can start to strategize ways to boost the profitability of your least-profitable customers — for example, by raising their prices or figuring out how to deliver products and services to them more efficiently.

Finally, you may determine that it's better to no longer work with some of the 80 percent of your least-profitable customers. It's not practical to "fire" all of the 80 percent — there will always be customers who rank in the bottom percentile when it comes to profitability. However, you can at least make strategic decisions about whether or not it makes sense to continue serving some customers who do not meet minimum profitability levels.

Concluding Thoughts

As applied to business, the 80/20 rule states that 80 percent of a company's profits come from 20 percent of its clients. If this is true, then it's very important to identify which 20 percent of your customers are contributing 80 percent of your profits. Doing so requires performing a comprehensive profitability analysis that looks at both hard and soft costs. An outsourced CFO services provider can help you identify all of the various costs associated with each of your customers so you can focus your resources on the 20 percent of customers who are adding the most profit to your business.

About CFO Edge

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