BT & Co. P.A.

Certified Public Accountants

Why you should track the cost of acquiring a new customer

For any business, understanding and effectively managing the cost of customer acquisition is crucial for success. But what exactly is the cost of customer acquisition, and why is it so important? In this document, we'll explain what it is, how it's calculated, and how it affects the profitability, cash flow, and overall growth of a business.

What is the cost of customer acquisition?

The cost of customer acquisition is a metric used to measure the financial costs associated with convincing a new customer to purchase your product or service.

To calculate your overall cost of customer acquisition, first add the total cost of sales and marketing expenses such as advertising, marketing, salaries, commissions, and any other costs related to acquiring customers for a specific period. Then, divide the total by the number of new customers acquired during that period. This will result in the average cost of acquiring a customer for that period.

Customer Lifetime Value

You should not pay more to acquire a customer than the total gross margin a customer will generate over their life as a customer. Therefore, it's important to calculate the customer's lifetime value.

Let's say a business sells widgets for $1,000 each. Each widget has a cost of goods sold of $400, which results in a $600 gross margin.

If each new customer only makes one purchase, the customer lifetime value will equal the gross margin on a single sale - $600. However, most businesses have repeat customers who purchase over and over until they stop being a customer one day.

Let's say the average customer purchases two widgets a year, resulting in $2,000 in revenue and $1,200 in gross margin each year. Additionally, the average customer life is ten years, meaning that the business loses 10% of its customers yearly to attrition. In this scenario, the customer lifetime value is calculated by multiplying $1,200 by ten years, resulting in a $12,000 lifetime value.

In this example, you would not want to pay more than $12,000 to acquire a customer. You would need to pay far less to profit from each customer.

Time to Payback

Unfortunately, most businesses must pay the cost of customer acquisition, all sales and marketing expenses, before realizing revenue from the new customer.

Investing in sales and marketing can cause significant cash flow issues, even if the customer lifetime value is significantly higher than the cost to acquire the customer.

The time to payback is an important metric measuring the time it takes a company to recoup the cost of acquiring a customer. The shorter the time to pay back, the less impactful the cost of acquisition is on cash flow.

Using the prior example, let's say the cost to acquire a new customer is $1,800. So, the business pays $1,800 to acquire a new customer who buys two widgets a year, generating $2,000 in revenue and $1,200 in gross margin each year.

In this scenario, the company is paying $1,800 to acquire a customer with a $12,000 lifetime value. Not bad.

However, since the average customer only generates $1,200 in gross margin each year, the time to payback is 18 months, and this is where cash flow becomes a problem.

If the business wants to acquire 100 new customers, it would need to invest $180,000 in sales and marketing. While the business would begin to generate additional revenue from the new customers, it would not recoup the full cash outlay for 18 months.

With a high customer acquisition cost, companies with limited financial resources may find it challenging to invest the money needed to hit their growth goals.

Growth and Customer Attrition

The cost of acquiring a customer becomes even more important when considering customer attrition and overall growth rates. Attrition is not a huge problem for startup companies but can be a significant problem for a more mature company with large customer base.

Continuing our prior example, let's say the company has 1,000 existing customers and would like to grow by 15% this next year. However, the company loses roughly 10% of its customers yearly to attrition.

To achieve a 15% growth rate, the company must first replace the customers it will lose to attrition and then acquire additional customers to achieve the 15% growth. In this case, the company would need to acquire 250 new customers: 100 to replace lost customers and 150 to achieve a 15% growth. To acquire the 250 customers at an acquisition cost of $1,800 would require an investment of $450,000 in sales and marketing.

As the customer base grows, the company will have to invest significantly more each year to cover customer attrition and maintain a 15% growth rate. Higher growth will require even more investment.

Growth Strategies

The cost of acquiring a customer drives profitability and cash flow, so it's important to measure and manage the metric continuously. The following are some suggestions for managing growth and the cost of acquisition.

Not all marketing channels and customer segments are the same. Thus, it's wise to calculate the cost of customer acquisition by marketing channel or customer segment. You can identify and prioritize your marketing spend on the most efficient channels. Unfortunately, no marketing channel is infinite, and as a company deploys more and more capital in sales and marketing, it will be forced to invest in less efficient channels, driving up the average cost of acquiring a customer.

Marketing strategies such as customer referral programs, word-of-mouth marketing, thought leadership marketing, and search engine optimization can help to reduce the overall cost of acquiring a customer. Unlike fleeting ads, these strategies draw potential customers indefinitely and at a lower acquisition cost.

Sending your prospects and customers highly personalized offers can help improve conversion rates and lower the cost of conversion. Accomplish this by using data analytics to segment your audience based on behaviors, needs, and purchase history to reach the right people at the right time with the right offers.

Cross-selling and upselling customers can help offset the revenue lost to attrition, increase customer lifetime value, and decrease the time to payback. Furthermore, if you're able to replace lost revenue with new sales from existing customers, it will reduce the sales and marketing spend required to hit your annual revenue growth goals.

If your customers purchase on a regular basis, you might consider offering a discount for prepayment. For instance, a 15% discount for an annual prepayment could significantly reduce the cash required to acquire new customers. It might cost $1,800 to acquire a new customer, but if you can receive $1,700 as a prepayment, the amount of cash tied up in sales and marketing is greatly reduced.

When determining a prepayment discount, you should consider your cost of capital and available credit. Interest rates are high, and traditional lending has become more restricted, making it more expensive to have cash tied up in sales and marketing. Thus, customer prepayments can help reduce cash requirements and fuel future growth.

Final Thoughts

We hope this document helps provide an understanding of how the cost of acquiring a customer affects the profitability, cash flow, and overall growth of a business. If you have any questions or would like to discuss tracking key metrics in your business, please contact our office to speak with one of our expert advisors.

About BT & Co. CPAs

From our founding in 1913 as a branch of Washington, Henry & Co., Federal Tax Consultants to officially becoming BT&Co. in 1989, a lot has changed – in our firm, our community, and in our profession. At the same time, many things at BT&Co. have stayed the same – our commitment to our community and our passion for helping our clients achieve success in their professional and personal lives.

We love numbers, but they don't fuel us. People are our greatest passion. What we do is serious work, but it doesn't have to be done void of personality and enjoyment- we don't ask our team to leave their uniqueness at the door. Our team redefines CPA daily.

BT and Company
4301 SW Huntoon St.
Topeka, KS 66604

(800) 530-5526

info@btandcocpa.com

www.btandcocpa.com