



"turning data into dollars"

Tom's Ten Data Tips – April 2007

### Customer Profitability

Measuring and understanding customer profitability at the individual level enables a firm to appreciate the distribution of relationship value so it can allocate resources accordingly. Valuation of a firm equals the aggregate value of its customer relationships. Hence, the search for shareholder value is akin to managing a portfolio of customers.

GM has always been renowned for their keen cost calculations. In the first half of the 20<sup>th</sup> century their purchasing model gave them a competitive edge. For decades GM enjoyed a 30 percent cost advantage over its direct competitors (including Ford and Chrysler) when the American market was still fiercely competitive. Their initial attempts at Activity Based Costing gave management the insight to steer the company towards profit and growth.

#### 1. Activity Based Costing Points Out Where You Can Compete

There is a direct line from corporate strategy, to meeting the market need, to creating value and customer profits. It has become clear that accounting's contribution to corporate strategy is not cost accounting, but rather value accounting. This transition parallels the move from calculating profit at the process or corporate level, to calculating customer profits.

A business aims to serve customers, and value is created if and only if customers can be served profitably. Insight in which segments and markets one can successfully compete in, is the primary driver of strategy evaluation.

#### 2. Activity Based Costing Enhances Internal Alignment

The shift from cost accounting to Activity Based Costing signifies a dramatic advance for IT in terms of adding value. Activity Based Costing began in manufacturing. Traditional product costing used to spread overhead as a function of direct labor hours per unit of product. Activity Based Costing is based on the premise that not products, but rather the activities in planning, procuring and producing products are responsible for costs.

Activity Based Costing allows management to focus on the factors that drive costs, rather than managing departmental budgets. Oftentimes cost centers that incur costs are not be responsible for actual costs. For example: quality problems may lead to costs for the service department, when really engineering may have done an inadequate design job. Driving out the discrepancies when costs are incurred (service/repair) versus when they are committed (design) is a major benefit of Activity Based Costing.

### 3. Customer Relationships Are Assets

Customer relationships are assets that should be managed as rigorously as any financial or physical assets. It is the *relationship*, not the customer that is the asset. This is because the relationship gives rise to future cash flows that can be estimated and valued. The firm's value is ultimately the sum of the value of its relationships.

It is in this sense that a firm manages, knowingly or not, a portfolio of customer relationships. By actively deploying and allocating resources, a firm seeks to maximize the value of its portfolio.

### 4. A Lifetime Is A Very Long Time

Customer Lifetime Value is like any asset value: it depends on the net cash flow over time. This is also referred to sometimes as "customer equity". The challenge in estimating cash flows further out in the future is that there are many possible career trajectories for a customer, each with widely different revenue streams. Also, attrition needs to be factored in, and in many industries this can have a large impact. As a result, Life Time Values become unreliable. Estimating as much as 2-5 years out with any reasonable level of reliability is often enough of a challenge already.

Investing in customer intelligence is profitable when the expected yield from improved customer portfolio management outweighs the costs of doing so. The costs of calculating Life Time Value need to be offset by better decisions on the basis of this knowledge.

### 2. Calculating Profitability Requires Committing To A Strategic View

Typically, calculating Activity Based Costing is not a matter of gathering more data, but rather a matter of consolidating information. Most companies already have some trace of customer activities that

are accountable for the costs in serving their customer. What needs to be gleaned from this, in close cooperation with finance people, is how fixed and indirect costs can be allocated to activities necessary to serve the customer. This is not an easy task, but deriving this financial model is essential in coming up with an equitable measure of Activity Based Cost.

The reason why this cost allocation is so hard, is because it requires making explicit ones philosophy towards the market (the "strategic view" on the market place). Where and how do you allocate indirect costs? For example: a financial institution will need to decide on which costs to allocate at the customer, and which costs at the account level. In logistics, it would be the choice between allocating at the customer or shipment level, etc.

#### 6. Incentive Systems Need To Drive Profit, *Not* Revenue!

Although BI may have insight into who are the best customers in terms of gross profit, this doesn't automatically mean this information will trickle down all the way to the sales force. Everybody "knows" that revenues do not equate profits, but unless *both* are explicitly stated, it is still anybody's guess. The calculations need to be as transparent as possible, to foster trust in the measures. A desirable side effect may be that front-line staff will become more aware of which products drive profits.

What is worse: as long as sales people's incentives are still driven by revenues (and not corporate profits), it's naïve to expect their efforts will be geared in any direction other than their own bonuses....

#### 7. Manage Profits Throughout The Customer Lifecycle

Although Activity Based Costing *began* in manufacturing, but it makes great sense in service businesses as well as non-profit organizations. It shows where expenses pay off in terms of the "value" being produced. Peter Drucker: "Activity-based costing therefore gives not only much better cost control; increasingly, it gives result control."

In particular for companies that offer a full line of services, understanding customer profitability becomes crucial in fulfilling a differentiated strategy. "Entry-level" products, or loss-leaders, need to be off-set by higher margins on subsequent cross-sell. This requires a deep understanding of the customer lifecycle and accompanying profit profiles.

## 8. Creating Value And Satisfying Customers Should *Not* Be A Conundrum

Some companies feel they need to “stretch” in between pleasing their customers, yet at the same time running a profitable business. What this really signifies is either a lack of strategic direction altogether, or not knowing how to execute the strategy in place. In today’s ever more competitive markets, it’s absolutely necessary to focus on generating value *for* the customer. However, generating *profitable* growth requires focusing on the right customer relationships.

Finding and delivering the right measurements (KPI’s if you may) is where strategy conception and execution come together. It’s where the rubber meets the road. Unless your strategy works for *both* your customers *and* your shareholders, you will not be creating sustainable value. Hence, business indicators of both customer perceptions and performance indicators that follow from strategy implementation need to be monitored on an ongoing basis.

## 9. Factor In As Many Indirect Costs As (Reasonably) Possible

When calculating customer profitability, the primary objective is to inform management about value creation and cost structures. Because direct labor costs have become a decreasing proportion of total costs, the impact of choosing a particular financial model on which customers show up as profitable, and which don’t, has grown.

It is important to note that since the purpose of calculating customer profitability is not to derive the corporate bottom-line, it need not match perfectly. There are some costs, like for instance the CEO’s salary, that are simply not related to customer activity. Such necessary costs of doing business need not be factored in, as long as the majority of indirect costs are. Sometimes, this is where interaction between marketers and accountants can be a struggle. Allocating indirect costs is a hard part of calculating customer profitability, and this sometimes requires considerable pragmatism.

## 10. Customer Profitability Aligns The Company With The Market

Customer profitability is like “true north” for a business. Unless you are maintaining profitable relations with your customers, you cannot run a profitable business. Then how come so many companies are sailing without a compass? Not all customers are created alike, but unless you quantify these differences, how can you sensibly differentiate?

For sure, many companies have *some* kind of measurement in place. But few, very few would bet the company on its accuracy. But then, aren't they doing exactly that by implication? Betting the survival of the company on *not* knowing customer profitability? We survived last year without running ashore, lets assume there will be no obstacles ahead next year and continue our course. In today's dynamic marketplace, that's no longer a safe bet. An improvement in determining the customer's profitability at the individual level forms a hedge against unforeseen "obstacles". On the positive side, learning *which* customers are most profitable and *why*, invariably proves enormously insightful.