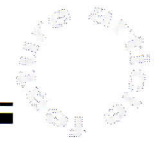

Customer Profitability

John A. Miller

Customer profitability quantifies the "in-the-bank" profits of the customer/supplier relationship and reports what's already been earned. More important to many industries is customer valuation, the future value of the customer. This article explains how the two differ—and why it matters.

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Profits earned on customers and customer segments may be one of the most important measures and yardsticks of organization performance. The bottom line on any customer (or customer segment) profit and loss statement represents the exchange of value between an organization and its customer.

Value to the customer is reflected in the selling prices that comprise revenues. Value for the supplier is reflected in the profit (or loss) from the relationship. Add in working capital, property, plant, and equipment investments made on the customer's behalf and the return on investment (ROI) on the relationship can begin to be understood.

This article provides an overview of customer profitability, including benefits, application and use, calculation alternatives, and best practices.

Customer profitability quantifies the "in-the-bank" profits of the customer/supplier relationship and reports what's already been earned. More important to many industries is customer valuation, the future value of the customer. The distinction between customer profitability and customer valuation is contained in the definitions below:

- *Customer profitability:* The periodic reporting of the profits earned on individual customers/customer segments. It's like reporting the profits of a business based on actual revenues and costs.
- *Customer valuation:* The lifetime value of individual customers/customer segments. It's like valuing a business based on projected revenues and costs (discounted).

A visual relationship of customer profitability and customer valuation is illustrated in Exhibit 1.

Customer profitability and customer valuation both require a definition of the customer or customer segments. Forward-looking customer valuation requires assumptions about future profit, attrition risk, customer loyalty, and economic and market growth (to name just a few). For customer profitability, these are not assumptions but what actually occurred in the reported financial results.

Projections of the future are significantly enabled with historical data and information. Without understanding the historic and current profitability of customer and customer segments, projections into the future would be difficult, if not futile. There would be no verifications or guidelines for future assumptions. Customer profitability is a prerequisite for customer valuation. For that reason, this article's focus is on the former.

BENEFITS

The primary benefit of calculating customer profitability is relevant and useful information required to develop strategic plans, enable better decision

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Published online in Wiley InterScience (www.interscience.wiley.com).
DOI 10.1002/jcaf.20404
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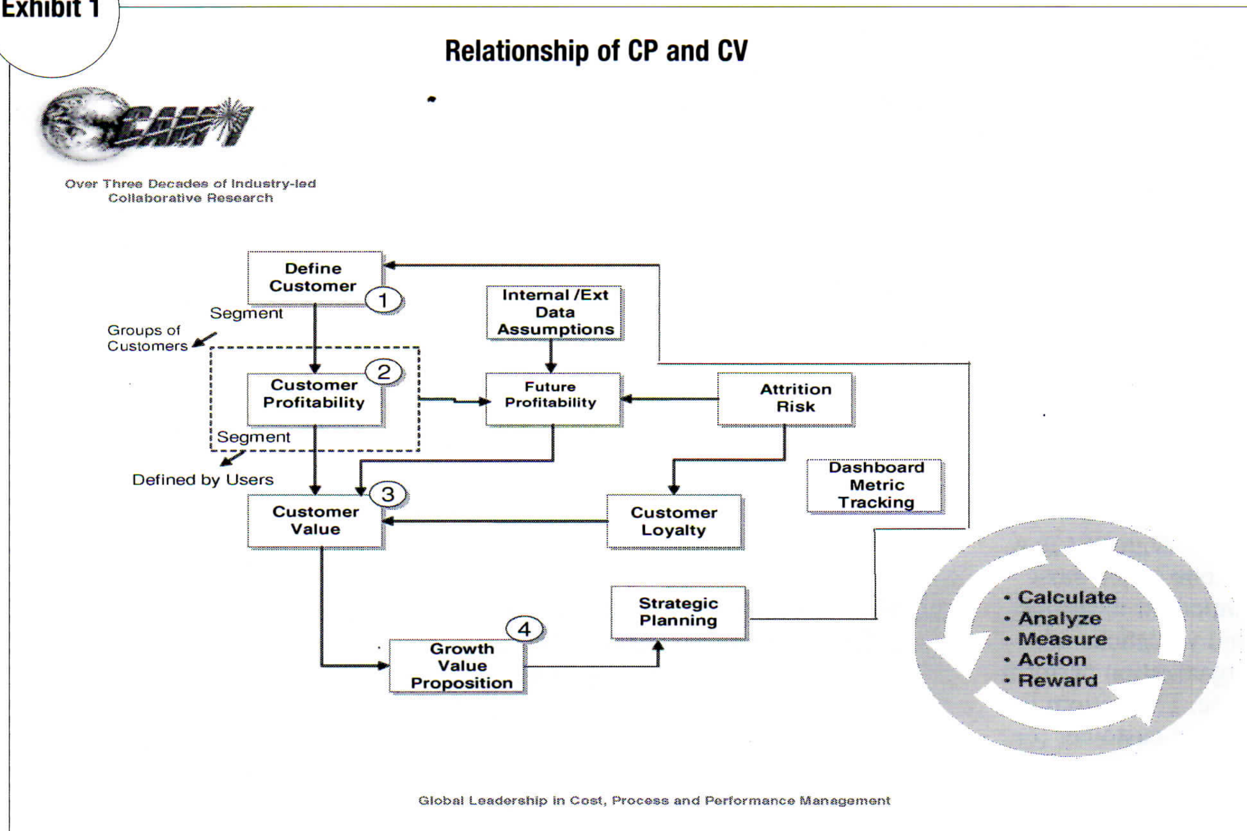
Exhibit 1

Relationship of CP and CV



making, and improve organizational performance and focus. Customer profitability quantifies the exchange of value that goes on between a business and its customers. For most businesses, the profitability of customers and customer segments varies substantially.

Customer profitability should be the core of the strategic plan and driver of operating priorities. Other than providing products and services to customers at a profit, what other reason is there for being in business? Decision makers in sales, marketing, and operations all benefit from customer profitability information. Examples of the application include the following:

- *Sales.* Keeps the sales organization focused on the high-value customers and identifies high-value customer opportunities. Customer cost-to-serve, used to eliminate/reduce customer behaviors that impact cost and for focused customer service levels (not all customers are equal).
- *Marketing.* Used to align marketing and promotion costs to key customer segments, reducing the risk of spending scarce marketing dollars to retain the least-valuable customers. Target new market opportunities and align new product/service development to the most profitable customers (both current and emerging).
- *Operations.* Basis for developing and executing competitively dominant customer value propositions.
- *Pricing.* Pricing decisions can differentiate service offerings in a way that is commensurate with the value of each customer. Customer profitability initiatives emphasize expanding services to existing customers through menu-based and service-level pricing. Increasingly, customers are requiring alternative pricing models and the unbundling of services and costs instead of a one-price-fits-all approach.

APPLICATION AND USE

The overall effort and requirement for calculating customer profitability varies significantly between industries and companies. Depending on the company, sales and revenues

DOI 10.1002/jcaf
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come from a handful of customers buying millions of dollars of a single product or from millions of customers spending a hundred dollars a week on a basket of groceries. In the first case, the company would know its customers by first name. The grocery store is unlikely to know the revenues of its customers or the products/services they purchased.

Some companies have data and information about each of their customers. For frequent flyers, airlines have data on flight frequency, destinations, revenues, and even seating preference. Other companies have no information on customers and rely on focus groups and customer sampling to segment and understand the revenues, product/service mix, and costs.

Companies with millions of customers, like utilities, telecom, and insurance, capture revenue and services for each individual customer in the monthly billing for electricity, mobile cell phone service, or an insurance policy. The monthly billing also provides them with the information on the products and services purchased. The availability of reliable customer data and information is significant to the overall work and requirement for calculating customer profitably.

One way to illustrate the differences between companies is by business model.

- *B2B.* Businesses selling to other businesses generally have a large amount of data about each of their hundreds or thousands of individual customers. Customer switching costs are moderate, and the customer/supplier relationship is often covered by short-term agreements and contracts. B2B applications of customer profitability include contract negotiation and establishing minimum order quantities, order frequency, and lot size. In times of tight supplies, it provides information to align capacity with the most profitable customers.
- *B2C.* Businesses that sell to consumers have millions of customers. Some of these businesses have a rich database of customer information, others very little. The switching costs for the customer (consumer) are low. Wal-Mart (data-poor) and Sprint/Nextel (data-rich) are examples. B2C applications of customer profitability include targeted marketing, pricing for product/service bundle, and service levels. The location of retail items and the layout of the floor space can be designed to appeal to the most profitable customers.
- *B2B2C.* Some businesses sell to businesses that, in turn, sell to the consumer. Their customers, distributors and large retail operations number in the tens of thousands, and consumers in the millions. These businesses typically know a lot about their customers and little about their consumers. Customer switching costs are high, and the customer relationship is covered by long-term contracts and agreements. General Motors and John Deere, who sell to independent branded distributors, are examples. Examples of B2B2C applications include optimizing distribution, product/service pricing, and focused marketing and promotional efforts.

Within a single company, its products and services could have elements of all three business models. The entire telecom industry is built around providing service to businesses or individual consumers, or through sale by third-party retail operations like Best Buy and Radio Shack.

> *The overall effort and requirement for calculating customer profitability varies significantly between industries and companies.*

CALCULATION

In making the customer profitability calculation, start with the end in mind. What will customer profitability information be used for? What decisions would be made with the information? How accurate does the calculation need to be? Who will use the information? How often will they need it? What costs are to be included in the calculation? All these questions should be answered and understood before the calculations are made.

The calculation of customer profitability itself is pretty straightforward. Revenues and cost (product/service cost and operating expenses) are assigned, traced, or allocated to customers or customer segments. For most organizations, the product and service portion of total cost is significant (over 75 percent). For these organizations, gross profit (sales minus the product/service cost) by

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customer may be sufficient to understand customer profitability. Matching customer/customer segment revenues with the cost of the products/services purchased is all that's required. For some organizations, it's the operating cost, not the product/service cost, that makes up 75 percent of the total cost structure.

In most organizations, the cost of products and services has been studied, documented, and made available in standard cost systems, activity-based costing models, or embedded in the organization's enterprise resource planning (ERP) and business intelligence (BI) systems. Operating expenses (selling, marketing, finance, information technology, and general and administrative) may be more elusive. Part of the operating cost is "business sustaining," with no cause-and-effect relationship to customers. These costs could be allocated arbitrarily (on revenues, for example) or excluded from the calculation completely. There is a cause-and-effect relationship between other parts of operating costs (sales, marketing, and parts of finance and administration) and the customer. With a little work and analysis, these costs can be appropriately assigned to customers.

More demanding is customer segmentation. Banks, insurance, telecom, utilities, and other companies can take revenues and a significant portion of their overall costs to individual customers and customer accounts. For decision-making purposes, this information is of little value. It's the segment the customer falls in that is important and necessary for decision making. For example, health insurance companies know revenues and claims (80–90 percent of all costs) for each insurance policy they sell. Some policies will have more claims than others. That's the nature of insurance, the sharing of risk over a broad population. What's important to the health insurance company is the profitability of the customer segment. The profitability of an individual customer is meaningless.

As one goes from a few customers you know to millions you don't know, the identification of customers and customer segment gets progressively harder. Retail operations and other businesses serving the consumer are constantly gathering sampling data to segment their customers into clusters that represent the products and services they want, buying habits and behaviors, and requirements.

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From a competitive standpoint, the goal is to segment customers into groups with homogenous needs so they can be approached, acquired, and insulated from competitive attack. The definition of a customer segment and trade-off is as follows:

- *Customer segment:* A group of customers with sufficiently homogeneous needs that the segment members can be won with a common value proposition and common marketing. A low degree of homogeneity reduces the likelihood of finding a value proposition that will satisfy most of the segment.
- *Trade-off:* Finer segmentation better focuses on customer needs that leads to better-crafted and more differentiated value propositions and greater acceptance, higher margins, increased loyalty, and higher economic profit. Too much segmentation leads to increased complexity, information overload, mixed customer messages, and little differentiation in the segment value proposition.

Conventional customer segments of a B2C business include age, annual household income, average purchase size, revenues, Zip Codes, occupation, and material status. Customer segments for Dell computer's business customers include small business, medium and large businesses, state and local governments, federal government, education, and health care.

In addition to conventional customer segmentation, some people get creative. Take Wachovia Bank, for example. They have five different segmentation programs, each with a key focus (in parentheses).

1. P$ycle or psychographic (market comparison);
2. Behavioral (cross-sell/upsell);
3. Book of business or value (cross-sell/upsell and retention);
4. Good to great or prospective value (market comparison and positioning); and

DOI 10.1002/jcaf
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5. Attitudinal (value proposition and design/development).

The multiple segmentation programs for Wachovia are enabled by the ability to capture costs and revenues at the account level. A database of profitability, at the account level, can be aggregated and segmented in multiple ways.

BEST PRACTICES

A great reference for organizations that have achieved success in their customer profitability initiatives is the best practice partners identified in the APQC/CAM-I consortium best practice studies. In two separate studies conducted in 2005 and 2007, eight companies were selected as best practice and significantly contributed to the body of knowledge around the practice, application, and use of customer profitability information:

- *FedEx:* Created a customer "desirability" model that considers customer profitability and other dimensions that are weighted to derive a relative value of the customer
- *Marriott:* Approximated customer profitability through an analysis of relative customer spending
- *North Shore Credit Union:* Used needs-based models (propensity) in conjunction with member profit scoring to derive a forward-looking measure of potential member value
- *Wachovia:* Leveraged account-level profit calculation from finance and aggregated this information at a relationship level; used a consistent approach and methodology regardless of line of business or customer segment
- *Zippo:* Calculated and reported customer profitability for each of its 3,500 customers; active proponent and user of activity-based costing for both product and customer profitability calculations
- *Charles Schwab:* Calculated and reported client segment profitability monthly; used current profitability, as well as assumptions of future behavior, to calculate customer value over a three-to-five-year time horizon
- *Aon Risk Services:* Aon's client-facing group tracked time spent on each of Aon's 10,000 customers and factored in direct costs, support costs, back-office costs, and marketing costs to develop customer profit and loss statements and scorecards
- *Sprint/Nextel:* Used a model to determine a customer lifetime value (CLV) for its active customers; updated CLV data monthly for its support analysis and distributed executive-level reporting on a quarterly basis

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Common practices among the study partners and deemed best practice included the use of multiple bases of customer segmentation, enabled by the ability to capture revenues and cost estimates for each individual customer account. Customer segments and subsegments are clearly defined and understood (typical were five to nine macro customer segments). As with any kind of initiative, buy-in from the users, upper-level support for the customer profitability initiative, and holding employees accountable for customer profitability were identified as prerequisites for success. Other best practices and findings:

- Include the majority of but not necessarily all costs in the customer profitability calculation. Costs included in the calculation are reconciled with reported financial results, and excluded costs are known and understood.
- Gear specific programs/sales efforts to most valuable customers. Most people are familiar with the Marriott Reward Program. FedEx has One Call for its most valuable business customers, and Zippo sponsors events for consumers and a swap meet for collectors.
- Convert unprofitable customers to profitable customers. None of the best practice partners "fire customers." When the value exchange with the customer is unprofitable, they work to fix the problem.

Finance and accounting professionals should be interested in one practice consistent across

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DOI 10.1002/jcaf

the partners and identified as critical to a customer profitability initiative. That practice was shared responsibility for ownership and customer profitability, bridging a gap between marketing and finance common in many organizations.

Customer-facing functions like sales, marketing, and operations are the primary users of customer profitability information. In many companies, this information is not available, so these groups make estimates of customer profitability, often based solely on revenue or proxies of customer behavior (such as points in a loyalty scheme). In making decisions to allocate scarce marketing, sales, service, or support resources, an imperfect estimate is better than nothing.

As official owner of the enterprise's financial statements, and practical owner of relevant operational applications like billing, finance is in the best position to understand the customer's profitability and to establish a repeatable and rigorous process for updating this analysis. Finance is also the group with the most credibility to make its estimates acceptable to the rest of the company, by reconciling the company's profitability (reflected in financial statements) with the total profitability of its individual customers. Although finance can generate numbers that reconcile, the assumptions that drive overhead allocation are often subjective and are only vaguely linked to the behaviors of individual customers.

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At the best practice companies, marketing and finance are jointly responsible for customer profitability. Each company had a dedicated group of two to five individuals involved in calculating and reporting customer profitability. These groups also work closely with the IT team to calculate profitability including data warehousing, the customer relationship management system, data mining, external databases, and predictive analytics.

SUMMARY

Long-term business success requires sustainable and profitable revenue growth. Customer/customer segment information provides an organization with the means to identify, create, and retain profitable customers, segments, markets, and channels. Understanding the cost of meeting unique requirements leads to more appropriate pricing decisions and value propositions for the customer. In looking at customer profitability, organizations use the information to define a profile and behavior of the kind of customers that are most profitable. With this information, advertising, marketing, and sales resources can be targeted to reach potential customers who fit the profile.

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DOI 10.1002/jcaf

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