



## **How to Measure and Manage Customer Value and Customer Profitability**



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## Table of Contents

<b>Executive summary</b> .....	1
<b>The “Perfect Storm” — creating turbulence for marketing management</b> .....	2
<b>Why do customer-related costs matter?</b> .....	4
All customers are not created equal .....	5
<b>Should we pursue the most profitable or the most valuable customers?</b> .....	6
A warning about CRM software .....	8
<b>Customer lifetime value — viewing customers as an investment</b> .....	9
<b>CLV math can be challenging.</b> .....	13
<b>Customer lifetime value</b> .....	14
<b>The CFO must serve the CMO.</b> .....	17
<b>Appendix 1: The basics of activity-based management (ABM)</b> .....	18
A true picture of customer profitability .....	19
The “M” in ABM .....	21

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## Executive summary

Estimating the ROI on purchasing equipment is near science. In contrast, determining the ROI on marketing programs may be considered by some more of an art than science. Thus, a large part of the marketing budget is typically based on faith that it will somehow grow the business. There is a very old rumored quote from a company president stating, “I am certain that half the money I am spending in advertising is wasted. The trouble is, I do not know which half.”

This expresses a concern—and it applies to the many marketing programs in addition to general advertising. Marketing spends money in certain areas, and the company hopes for return. Was that brochure we just mailed a waste or did it actually influence someone to purchase? Senior management has had the unquestioned view that marketing and advertising are things you must spend money on—but how much money? How much is too much? Where is the highest payback area to focus on and which areas should be avoided?

Companies are extremely vigilant about all spending. They often exercise draconian actions, such as layoffs, to right-size their cost structures. The budget expenditures for marketing should be subject to the same intense examination by the COO and CFO as any other spending program. The ROI on marketing, and each marketing program or campaign, must be better projected—not with fuzzy math but by using modern analytical techniques, fact-based logic and financial data. After all, in the absence of facts, anyone’s opinion is a good one. (And the biggest opinion usually wins!) Many marketing functions rely on imperfect metrics, anecdotes and history that may have resulted from unusual occurrences unlikely to be repeated.

I am not arguing to slash all marketing budgets by exposing them as a waste. In fact, I mean just the opposite. My belief is that the marketing spend is critical—but it should be treated as a precious scarce resource to be aimed at generating the highest, long-term profits. This means there is the need to answer questions such as: “Which type of customer is attractive to newly acquire, retain or win back? And which types are not? How much should we spend attracting, retaining or recovering them?” Some firms have already enacted programs in these areas to begin trying to answer these questions. More must.

Although the marketing and sales functions clearly see the links between increasing customer satisfaction and generating higher revenues, accountants have traditionally focused on encouraging cost reduction as a road to higher profits. One way for investors, shareholders and a management team to think about measuring a company’s promise for long-term economic value growth performance is to measure its customers. Although today the CFO’s managerial accounting planning and control systems typically focus on operations management, CFOs are now shifting their assistance to the chief marketing officer (CMO) and the benefits can be substantial.

One way to think about measuring a company’s promise for long-term economic growth is to measure its customers.

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## The “Perfect Storm” — creating turbulence for marketing management

In the last 10 years, five major forces are converging to place immense pressure on companies, particularly on business-to-consumer ones (B2C):

- **Customer retention.** It is generally more expensive to acquire a new customer than to retain an existing one—and satisfied existing customers are likely to buy more and also “spread the word” to others—like a referral service! Hence the increasing focus on customer satisfaction. The emphasized trend today is growing existing customers and making them loyal rather than a focus on acquiring new ones. As a result, loyalty programs and other frequency points programs have grown in popularity.
- **A shift in the source for competitive advantage.** In the past, companies focused on building products and selling them to every potential prospect. But many products or service-lines are one-size-fits-all and have become commodity-like. To complicate matters, product development management methods (PDM) have matured and accelerated quick, me-too copying of new products or service-lines by competitors. Consequently, as products and service-lines become commodities, where competitors offer comparable ones, the importance of service rises. There is an unarguable shift from product-driven differentiation toward service-based differentiation. That is, as differentiation from product advantages is reduced or neutralized, the customer relationship grows in importance. This trend has given rise to many marketing organizations focusing on segment, service and channel programs, as opposed to traditional product focused initiatives. Business strategists all agree that differentiation is a key to competitive advantage. This was a main revelation in Michael Porter’s seminal book published in 1985, *Competitive Advantage*, which launched strategic planning as an essential company function.
- **“One-to-one” marketing.** Technology is being hailed as an enabler to: (1) identify customer segments, and (2) tailor marketing offers and service propositions to individual customers (or segments). There is now a shift from mass marketing products a seller believes it can sell to better understanding each customer’s unique preferences and what he or she can afford. You may even need to better understand your customer’s customer. Traditional marketing measures such as market share and sales growth are being expanded to more reflective measures of marketing performance, such as additional products and services sold to existing customers. There is frequent reference to “share of customer wallet.” Customer lifetime value, to be discussed later, is a trendy new indicator for customer economic value. In short, the message is that companies must now continuously seek ways to engage in more content-relevant communications and interactions with their customers. Each interaction is an opportunity to gain knowledge about customer preferences—and to strengthen the relationship.

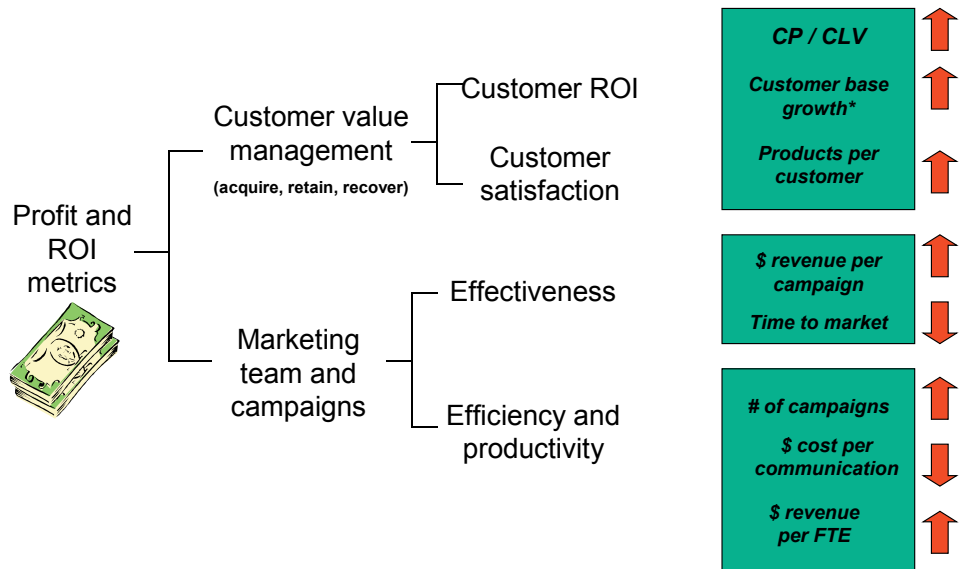
- **Expanded product diversity, variation and customization.** As product and service-lines proliferate, such as new colors or sizes, complexity increases. As a result, more indirect expenses (i.e., overhead costs) are needed to manage the complexity; and indirect expenses are increasing at a relatively faster rate than direct expenses. With indirect expenses growing as a component of an organization's cost structure, the managerial accounting practices typically require enhancing. (Many costing systems arbitrarily allocate overhead to products based on broad-brush averages, such as product sales or direct labor hours; so they do not reflect each product's unique consumption of indirect expenses. Activity-based costing [ABC] is now accepted as the method that resolves this problem. ABC traces and assigns costs based on cause-and-effect relationships.) This does not mean that an increase in overhead costs is a bad thing. It simply means that a company is required to invest and spend more on expanded product offerings and services to increase its customers' satisfaction.
- **Power shift to customers.** The Internet is shifting power—irreversibly—from sellers to buyers. Thanks to the Internet, B2C consumers and B2B purchasing agents can more efficiently explore more shopping options and more easily educate themselves. Customers have an abundance of options; and now they can get information about products or services that interest them in a much shorter amount of time. The customer is in control more than ever. Consequently, from a supplier's perspective, customer retention becomes even more critical and treating customers as “a lifetime stream of revenues” becomes paramount. This shift in power from sellers to buyers is placing relentless pressure on suppliers. Supplier shakeouts and consolidations are constant.

When it comes to measuring the overall marketing function, unfortunately many companies miss the ROI mark.

The combination and convergence of these five forces means that suppliers must pay much more attention to their customers. The implication is clear. Profit growth for suppliers and service-providers will come from building intimate relationships with customers, and from providing more products and services to one's existing customer base. Earning, not just buying, customer loyalty is now mandatory. But how much should you spend in marketing to retain customers, and which type of customers should you spend more on? Few organizations can answer these questions. Few organizations know what they spend today.

When it comes to measuring the overall marketing function, unfortunately many companies miss the ROI mark. They do not have meaningful, consistent and reliable marketing performance metrics. Worse yet, in an attempt to build customer loyalty, they continue to deploy blanket mass-marketing strategies rather than differentiate (i.e., segment) their customers based on cross-sell and up-sell opportunities.

Good customer intelligence systems help organizations make smarter decisions faster. A workflow or business process without the ability to measure, analyze and improve its effectiveness simply perpetuates a problem. A good customer relationship management system (CRM) allows end-to-end functionality from sales lead management to order tracking—potentially seamlessly. Figure 1 illustrates key components for measuring the performance of marketing with examples of performance metrics.



**Figure 1: Marketing Metrics Decomposition Tree**

The top half of this decomposition tree is on customer value management, which is the topic of this paper. The lower half describes the effectiveness and productivity of the marketing function itself and one of its tools of the trade – marketing campaigns. The CFO should help the CMO measure both. Let’s now dig deeper into the two key financial measures for customer valuation management: customer profitability and customer lifetime value (CLV).

### Why do customer-related costs matter?

Increasing the profitability of each customer, not simply its products, is a way to sustain long-term economic value growth for the enterprise and its investors. How many customers does it have? How much profit is being earned from each customer (or at least each customer segment) today and in the future? What kind of new customers are being added and what is the growth rate of additions? How and why are customers migrating through segments over time?

As a result of varying customer demands for different levels of service, the cost-to-serve component of each customer’s profit contribution requires measurement and visibility. As widely varying customization and tailoring for individuals becomes widespread, how will companies distinguish their profitable customers from their unprofitable ones? In a sense, it is these



customers who are partners selected to grow the supplier's business and wealth creation. Companies now need financial measures for how resource expenses are uniquely consumed, below the gross margin line, by each diverse customer.

The problem, however, is that the managerial accounting systems of most companies concentrate on product or service-line costs (which it was noted earlier are flawed and misleading by arbitrary cost allocations) because regulatory financial accounting rules (i.e., GAAP) require compliance. But when it comes to the below the gross margin line expenses, such as distribution channels, sales and marketing, accounting rules require these expenses to be recognized during the month period in which they were incurred; they cannot be capitalized and stored in the balance sheet as inventoriable product costs can. Accountants refer to these as period costs. But, classifying expenses that way is for external financial accounting for banks, investors and regulatory agencies. What we are discussing here is internal managerial accounting to support the analysis and decision making of managers and employee teams. Accountants must begin applying the same costing principles for product costing, typically ABC principles, to types of channels and types of customers so there is visibility to all traceable and assignable costs. Otherwise, you have no clue where you are making and losing money.

In the end, services will be added to products, and unique services will be tailored for individual customers. ABC data will be essential to validate and prioritize the financial merits of which services to add for which customers.

### All customers are not created equal

There is an unchallenged belief that focusing solely on increasing sales dollars will eventually lead companies to depressed profitability. What matters is a mind-shift from pursuing increased sales volume at any cost to pursuing profitable sales volume.

Some customers may purchase a mix of mainly low-margin products and service-lines. After adding the "costs-to-serve" such as phone calls for customer service, transactions exclusively in high-cost channels or special delivery requirements, these customers actually may be unprofitable. Other customers who purchase a mix of relatively high-margin products may demand so much in extra services that they also potentially could be unprofitable.

How does one properly measure customer profitability? How does one migrate unprofitable customers to profitability or de-select them and eventually "urge them out"? After the less profitable customers are identified, how can they be managed toward higher profitability? How can profiles of existing highly profitable customers be applied to attract new customers with similar characteristics? To answer these questions, first you need to properly measure the level of customer profitability (or at least segments of customers).

To be competitive, a company must know its sources of profit and understand its cost structure. For outright unprofitable customers, a company should explore passive options of substantially raising prices or surcharging its customers for the extra services. Again, in most cases this will establish the corrected "market-driven" value proposition between the company and the customer, resulting in either a profitable customer or intentional customer attrition by terminating the relationship. Remember, sending an unprofitable customer to your competitor isn't a bad thing.

ABC data will be essential to validate and prioritize which services to add for which customers.

For profitable customers, increased profit margins can be accomplished by doing the following:

- Manage each customer's costs-to-serve to a lower level.
- Improve and streamline customer facing processes, including adding self-service models where possible.
- Establish a surcharge for or re-price expensive cost-to-serve activities.
- Reduce services; focus first on labor intensive ones that add the least value yet cost the most.
- Introduce new products and service lines.
- Raise prices.
- Abandon products or service-lines.
- Improve and streamline internal business processes.
- Offer the customer profit-positive service level options with varying prices.
- Increase investments on activities that a customer shows a preference for.
- Up-sell or cross-sell the customer's purchase mix toward richer, higher-margin products and service lines.
- Discount prices to gain more business with low cost-to-serve customers.

But to take these actions, a company first needs fact-based data about its profits and costs. With this, management will have reliable cost information that can be used to build solid business cases for actions instead of relying on potentially risky intuition or hunches or, worse yet, flawed and misleading cost data.

Focusing on the most valuable and most growable customers in the short- and long-term can have a large impact on the bottom line. But many marketing retention and acquisition programs do not effectively center on the more profitable customer segments, but rather indiscriminately on the entire base. Having a way to value different types of customers is powerful for developing customer-centric strategies and subsequently determining what level of priority and effort to engage each customer segment.

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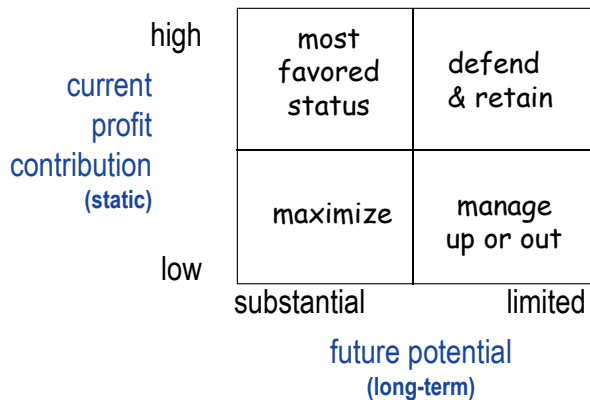
### **Should we pursue the most profitable or the most valuable customers?**

The goal of marketing is to not only identify potential new customers, but to reach out to existing customers through cross-selling (e.g., when I sell you golf clubs, I try to sell you a golf glove) and up-selling (e.g., when I sell you a shirt, I offer a second one at a lower price.). Maximize the value of the relationships you already have.

Metrics to evaluate customers might include: retention (loyalty) rates, attrition rates, churn propensity and the marketing standard metrics trio of a customer’s purchase history: recency, frequency and monetary spend (RFM). Indirect considerations can include a customer’s referral propensity to recruit new customers. Of course, there is a myriad of other socio-demographic (e.g., age, income level, gender) and attitudinal variables that marketers analyze about their customers to understand their tastes and preferences. Data mining tools are becoming essential for marketers to formulate tailored marketing campaigns for the customer segments defined by their analysis.

Figure 2 illustrates that just knowing the existing level of profitability for a customer may not always be sufficient. For some types of customers, such as a young promising dentist or imminent university graduate, their potential future profit as a customer is sizable though their current level of profitability does not reveal this. So their future potential also should be considered. Each quadrant in the figure suggests which action to take toward a type of customer to improve profitability.

There appear to be obvious customer strategies for each category.



**Figure 2: Current vs. long-term potential customer value**

But there can be risks to acting automatically based on a customer’s current quadrant location. For example, you could misjudge customers with current low profits as being low future potential and abandon them, thus missing substantial future profit opportunity. For high future potential customers, you could unwisely entice them with loss leaders only to not have profit followers to recoup the losses or, worse, lose their business to a competitor. Reacting to a customer’s quadrant location also can get complicated. For example, if a student, currently an unprofitable bank customer but the niece of her highly profitable aunt, requests her bank to match an auto dealer’s low loan rate offer thus making her more unprofitable to the bank, do you reject the niece and jeopardize the relationship with her aunt? Or do you accept her, seeing the potential to cross-sell (e.g., credit card) and generate long-term profits?

Another risk may be revealing too much about your decision process to customers, and potentially appearing foolish or mean to them. Customer intelligence systems using data mining techniques can be designed to send data into the operational CRM systems derived from the profitability data. So, for example, a bank teller should not say to a customer, “You’ve got a low profit score, so therefore I cannot waive your service charge” but rather say, “I’m sorry, but we already extended our one-time courtesy waiver, so I can’t waive your service charge at this time.”

These examples go to the heart of customer relationship management systems. Decisions should be made considering the more valuable customers, not just the currently more profitable customers. These examples involve balancing current customer satisfaction with shareholder ROI demands—and both involve tradeoffs among short-term and long-term decisions:

- **Achieving customer satisfaction and intimacy.** Gaining customer loyalty is more than “bribes” with perpetual discounts. Loyalty must be earned, not bought. So-called “loyalty” programs are typically just frequency programs lacking intimacy.
- **Increasing the company’s profitability.** How do we apportion our marketing spend between customer retention and new customer acquisition or recovery (i.e., win-backs)?

The marketing function increasingly requires more financial analysis for trade-off analysis. Measuring customer lifetime value is one of those methods.

### **A warning about CRM software**

Unfortunately CRM software typically lacks analytical rigor defaulting to an emphasis on collecting data and displaying standard reports (e.g., sales pipeline) or vague indicators (e.g. last purchase date and amount). After heavy investments in CRM, companies still ask, “Which are our most and least valuable customers?”

Progressive customer intelligence (CI) tools with powerful data mining functions provide much more business intelligence. The analytical CI system facilitates the integration of the front-office, customer-facing CRM systems to ensure coordination and sharing of a consistent message. That is, data from multiple communication channels can be consolidated to create customer intelligence for each customer, and then the analytical CI system can formulate and “push” the appropriate intelligence into the front-office CRM channels.

## Customer lifetime value — viewing customers as an investment

To consider the future profit potential of customers, marketing and sales functions have begun exploring an equation called “customer lifetime value (CLV)” that treats each customer (or segment) as an investment instrument similar to an individual stock in a portfolio. There can be winners and losers. Since changes in customer behavior usually are not volatile, CLV may be useful to understand profit momentum. CLV measures are not interrupted by “one-time charges” and other short-term, but substantial, financial statement surprises. CLV links customer revenues to organizational profits. They should never be assumed to always go in the same direction because, as earlier mentioned, high maintenance customers can be unprofitable regardless of their sales volume.

CLV is a forward-looking view of wealth creation. CLV can be defined as the net present value of the likely future profit stream from an individual customer. This involves multiperiod discounted cash flow (DCF) investment evaluation math, not just a single period. This math gets trickier than measuring historical customer profitability levels because you need to consider factors other than what did happen. CLV also considers the probability of losing some customers. By using DCF math, you can equate the future stream of net cash flow (profits) into a single cash amount (i.e., the expected value) of profit stated in today’s money.

An appeal of CLV is that it focuses on the customer as the influencer of a company’s profitability rather than the products and service-lines (although they are inclusive in the CLV equation). Another appeal of CLV is it also can be applied to evaluate which new customers, not just existing ones, to target and attract through marketing campaigns and, most importantly, how much the firm can afford to spend on acquiring new customers based on their CLV. Figure 3 illustrates some of the tactical actions mentioned earlier that a company may take to lift the profitability of a customer relative to the customer’s current expected lifecycle.

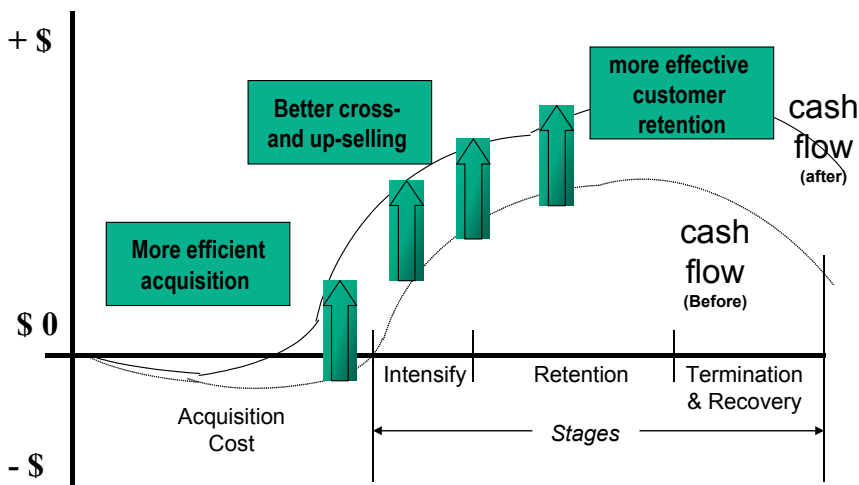
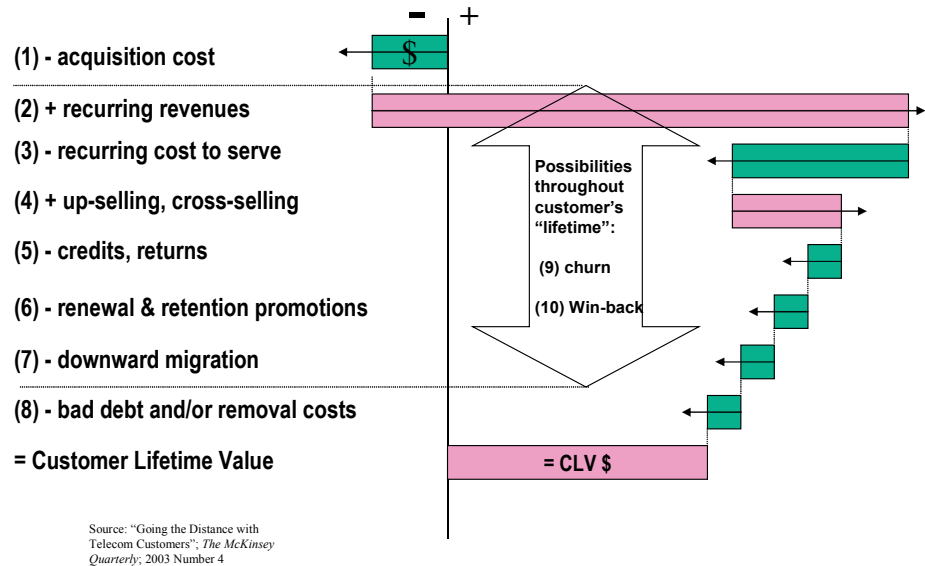


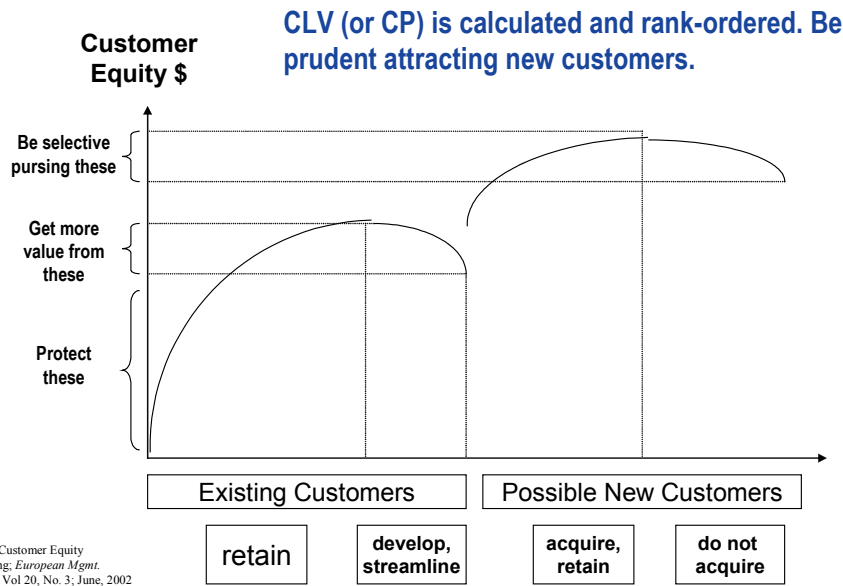
Figure 3: Customer lifecycles can be leveraged

Figure 4 illustrates 10 revenue and cost elements that determine the CLV of a customer segment over its lifetime. Ideally, the marketers would tailor marketing campaigns to assure this planned CLV of each segment is realized. Understanding the CLV of existing customers allows creating profiles, based on characteristics of customer segments, to attract similar types of new customers.



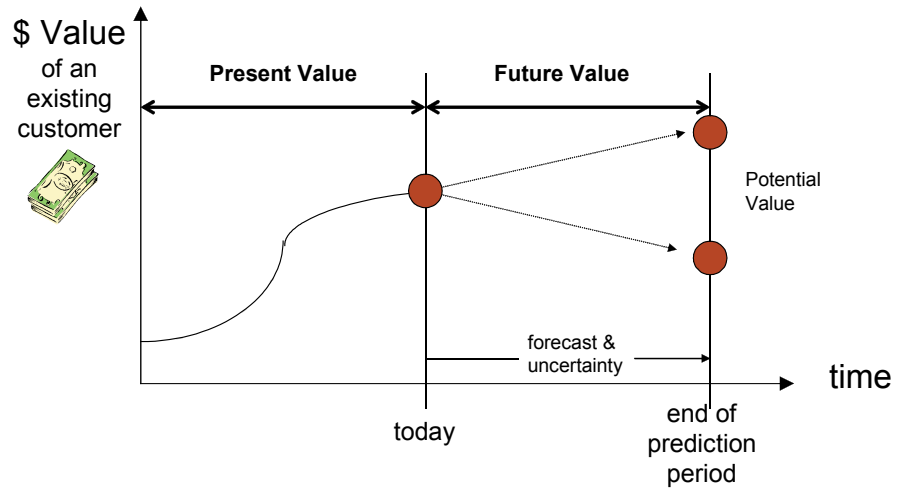
**Figure 4: Determinants of customer lifetime value (CLV)**

Figure 5 illustrates actions and priorities and is a companion figure to Figure 2. All customer segments should be managed for higher value, but the strategies will differ depending on the segment. The graph line is rank ordered from highest to lowest CLV. The most valuable customer segments should be protected—their retention being the high priority. Earning their loyalty is critical. The less valuable customer segments should be managed for higher returns. For new sales prospects, marketing can allocate appropriate budget to acquisition programs to attract customers with “clone” characteristics to valuable existing customers. The marketing budget spending should focus on higher payback rather than on potentially unprofitable sales prospects.



**Figure 5: Value creation via CLV**

Figure 6 illustrates that assumptions and forecasts with uncertainty are involved in calculating CLV. Even with customers segmented, forecasting models can be quite sensitive to assumptions. For example, how long will an active customer continue the relationship? How much and when will an active customer spend? If a customer is inactive, is it temporary or did they switch to a competitor? If so, what and how much are they purchasing from a competitor? They may spend \$100 with you but \$500 with your competitor. For these last two questions, you only see your data, not external data, forcing you to make assumptions about the missing data. But that simply means you will need to gain more competency in statistical forecasting. It's inevitable that to truly manage performance there will be a shift in competencies from control to planning.



**Figure 6: CLV depends on predictions**

Customer Equity (CE) is becoming the buzzword among marketers and is based on CLV math. CE is an acquisition and customer retention management strategy geared to economic value creation for shareholders. Figure 7 displays a simple equation for computing CE as being the sum of the CLVs for both existing and future customers.

$$CE = \sum CLV \$ \text{ existing customers} + \sum CLV \$ \text{ new customers}$$

Where CLV is “the net present value of the likely future profit stream from an individual customer.”\*

$$CLV \$ = (- \text{acquisition cost}) + \sum (\text{monthly \$ margin})$$

adjusted for probable number of years of retention

\* Peppers and Rogers Web site glossary

**Figure 7: Customer equity (CE) involves math**



## CLV math can be challenging

There are some questions, challenges and difficulties involved with computing CLV. For example, the CLV equation works assuming that the start time for measuring it begins with today. Given this, do you need to go back in time and determine what historical acquisition cost was for existing customers? And how would you derive that amount? Or alternatively, should you treat past acquisition costs as a sunk cost? Also, how should you assign retention-related expenses? How many periods into the future should be used since CLV is a discounted cash flow investment calculation, not a past period static one?

Figure 8 is one example of how deep theorists can get into developing CLV equations. I would not endorse starting off with elaborate CLV equations of this type. A compromise can involve simpler equations, using computer modeling, for estimates of the elements in Figure 4. The benefits will be more in the organization’s learning about how to view its customer segments and how to think about the probabilities for elements such as churn and win-backs.

$$CLV^k = \sum_{t=0}^{t=T} \frac{E_t^k - A_t^k}{(1+i_t)^t} = \left[ \overset{\text{Present Value}}{E_0^k - A_0^k} \right] + \left[ \overset{\text{Future Value}}{\frac{E_1^k - A_1^k}{(1+i_1)^1} + \frac{E_2^k - A_2^k}{(1+i_2)^2} + \dots + \frac{E_T^k - A_T^k}{(1+i_T)^T}} \right]$$

- $CLV^k$  = Customer Lifetime Value of a customer  $k$
- $E_t$  = revenue from a customer  $k$
- $A_t$  = expenses for a customer  $k$
- $k$  = customer  $k$
- $t$  = time period ( $t=0, 1, 2, \dots$ )
- $(t=0)$  = today
- $T$  = predicted duration of a customers relationship
- $i$  = interest rate

**Figure 8: Calculation of a CLV can be complex!**

The difficulty with determining the length of the proper planning horizon can be resolved by simply limiting it to only a few years. With DCF’s ‘net present value,’ the impact of time on the ‘expected value’ quickly diminishes beyond the fifth year. Regardless, most marketing programs should be examined for these shorter terms.

Because CLV can be difficult, is it worth it? Is the climb worth the view?

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## Customer lifetime value

CLV is understandably perceived as difficult to calculate with any degree of certainty. It is also perceived as hard to use. Hence, those managers who are cognizant that customers generate different profit levels relative to their sales typically only have confidence in a customer's current profitability—that is, if their accountants are measuring it, which most aren't.

So, is it feasible to measure CLV and is it practical to try? Is it worth the effort? What are the conditions or situations where using CLV data makes sense? Measuring CLV will likely go through a test period for acceptance. CLV will be evaluated to see if its benefits are worth the administrative effort to measure it. For some companies, periodic customer profitability reporting with ABC can be a sufficiently good proxy or surrogate for the CLV measure. This could preclude any need to get more sophisticated. Companies with ABC systems have proven they can repeatedly and reliably report and score customer profitability information. The benefits with actual customer profitability reporting come from the insights managers and analysts gain by comparing profiles of customers with varying degrees of profitability. This information alone may be sufficient to formulate new marketing strategies and to budget future marketing spending for higher payback.

As earlier stated, it is becoming clear that acquiring (or focusing on) less profitable customers may be an inefficient use of the marketing spend. Hence, adding customer profit differentiation as a segment for formulating tailored marketing campaigns is a good thing. The 'administrative effort' test involves how much more useful will it be to know how profitable customer segments could be compared to knowing (and managing) what is the current run-rate of existing customer profits? Restating this 'effort' question, is it more useful to impose on marketing the need:

- To apply assumption-laden investment calculations about customers?
- To encourage evaluative analysis based on differentiation of varying past period customer profitability?
- To apply this classic marginal costing validation test?  
(change in \$ sales > change in \$ costs)

There are conditions where CLV is more or less applicable. CLV works better in industries with:

- A high cost to acquire, retain or 'win back' customers (e.g., financial institutions, airlines or hotels).
- Highly disproportionate skew of many transactions from a customer subset, but with a relatively low per-transaction cost to serve them.

Furthermore, CLV is more applicable when you have a database with customer profiles and their transaction history data. That is, you already know a lot about them. CLV is less applicable if you work through B2B sales channels that preclude a direct relationship, and hence intelligence, with end-consumers.

Figure 9 is a table that provides guidance as to when it may not be appropriate to advance to the higher stage of maturity for measuring customer valuation. That is, it may be sufficient to simply begin with measuring current profitability for existing customers rather than advance to the more sophisticated CLV. Figure 9 basically says that CLV is more applicable for business-to-consumer (e.g., retail, residential telecom, or airline) than it is for business-to-business (B2B); however, some B2B customers will go through lifecycles, such from a start-up to a midsize company, so CLV is applicable for B2B in some cases.

**Managerial Uses**

	<b>Strategy Formulation</b>	<b>Customer Potential Lift</b>
CP only	B2B segments	less applicable with B2B – less lifecycle considerations
CP and CLV	B2C segments	individual customers (existing & future)

*Customer Decisioning*

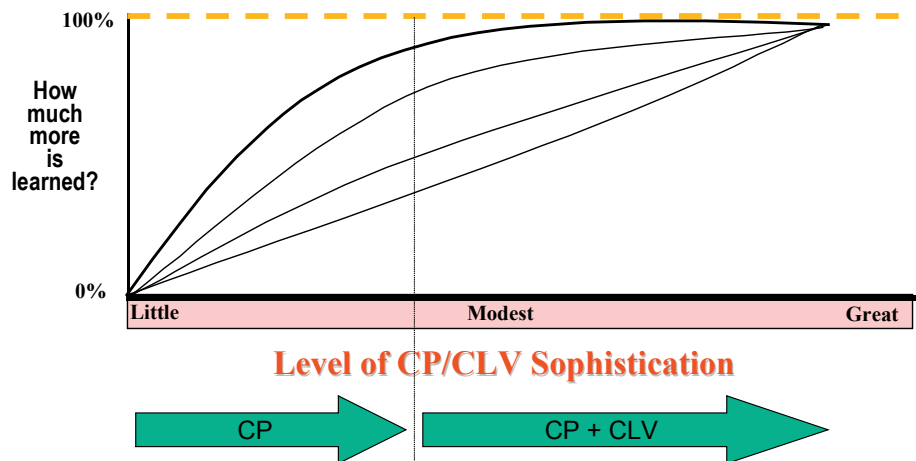
**Figure 9: Conditions for using CLV**

The table’s columns are the two main uses and purposes for applying CLV data:

- **Formulating different tailored marketing strategies for different customer segments.**  
 The duration of B2B relationships tend to be longer and less volatile than B2C. There is less churn by companies than consumers (an exception to this is very small businesses); and companies tend not to have defined lifecycle stages that individuals pass through, such as from starving student to parent to retiree. (Although some do evolve from a start-up stage through mid-cap to a large business stage.) Hence, past customer profit is likely representative of potential profitability too; and it can be used for formulating strategy. In contrast, marketing strategies for consumers are designed to migrate them to more profitable segments (e.g., the General Motors’ ladder of Chevy to Buick to Cadillac). CLV recognizes future potential value.

- **Triggering a profit lift with a deal or an offer.** Customer profitability and CLV are useful to tailor a proposition to individuals based on timely transactional data about that individual. True B2C. For example, when Mary Smith places an inbound call to a call center, it matters if she purchased a big-ticket item last week. Mary is not an average. Mary's purchasing behavior and responses to other promotions are being data mined and analyzed. Whereas grouping individual B2B customers and consumers into customer segments is appropriate for formulating tailored strategies, it is not for customer decisioning of consumers by communication channels (e.g., e-mail, call centers, mailing brochures, newsletters). In contrast, sales teams or individual salespersons typically analyze and strategize on B2B business data.

Figure 10 illustrates the rate of learning about a customer's value relative to the level of analytical sophistication. It implies that much can be learned just with measuring customer profitability and applying rank-orders to formulating marketing strategies. Beyond that, adding CLV insights about future potential can add to the learning and enhance formulating even better marketing strategies.



**Figure 10: Use customer profitability as a proxy for CLV?**

There should be little argument, given the power of computers and data warehouses, that computing CLV with some degree of accuracy is feasible. The key question is: do I learn enough from calculating CLV amounts to be worth the effort? As you have learned here, the answer to this depends on many factors with the most important being the type of business.

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## The CFO must serve the CMO

We began this discussion stating that senior management has had unquestioned views that marketing and advertising is something it must spend money on—but how much money? How much is too much? Where is the highest payback to focus on and where should you avoid?

It is inevitable that the answers to these questions will require a contribution from the business analysts using managerial accounting techniques. The day is coming that the CFO function must turn its attention from operations and cost control to the CMO and customer and cost planning and shaping.

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## Appendix 1: The basics of activity-based management (ABM)

Why have organizations been adopting activity-based management (ABM) as their costing methodology? A primary reason has been a significant shift in most organizations' cost structures. Over the last 20 years, organizations have offered an increasing number of product types and service-lines, delivered through different channels, and provided to increasingly more granularly segmented classifications of customers.

Whenever any organization expands the diversity and variation of its outputs and the types of customers it serves, this produces complexity. And increased complexity means you need more indirect and overhead expenses to manage it. As a result, the overhead and indirect expenses, such as for middle managers and 'back-office' operations, have been displacing the recurring and repeatable direct costs typically associated with traditional front-line workers. (This was described as factor 4 of the "Perfect Storm" impacting marketing.)

The costing methodology problem is that most organizations arbitrarily allocate their indirect expenses to products or service-lines using broad-brushed, volume-based averages rather than trace and assign these expenses into calculated costs using cause-and-effect factors.

The ABM methodology does not simply presume that products or customers consume indirect resource expenses based on flawed unit-costing math. ABM begins with the logic that customers and products place demands on work activities performed (activities that belong to business processes), and the work activities then draw on the organizational spending that senior management sanctioned as authorized budgeted capacity. Rather than grouping expenses by departments or cost centers, ABM disaggregates cost centers into the work that people and equipment do, and then it calculates the output costs of work as a consumption network.

This results in substantially higher cost accuracy compared to traditional costing methods that, in reality, over-cost and under-cost products compared to ABM calculation. ABM is a superior costing method because it complies with the principle that "costs are measures of effects from demands on work."

An organization's executive management and employee teams need detailed product, channel and customer cost information to make specific decisions regarding product pricing, mix, service levels or dedication of its resources. Figure A illustrates the progressive stages of maturity ranging from the primitive broad-average allocation method to the multi-stage cost assignment technique of ABM.

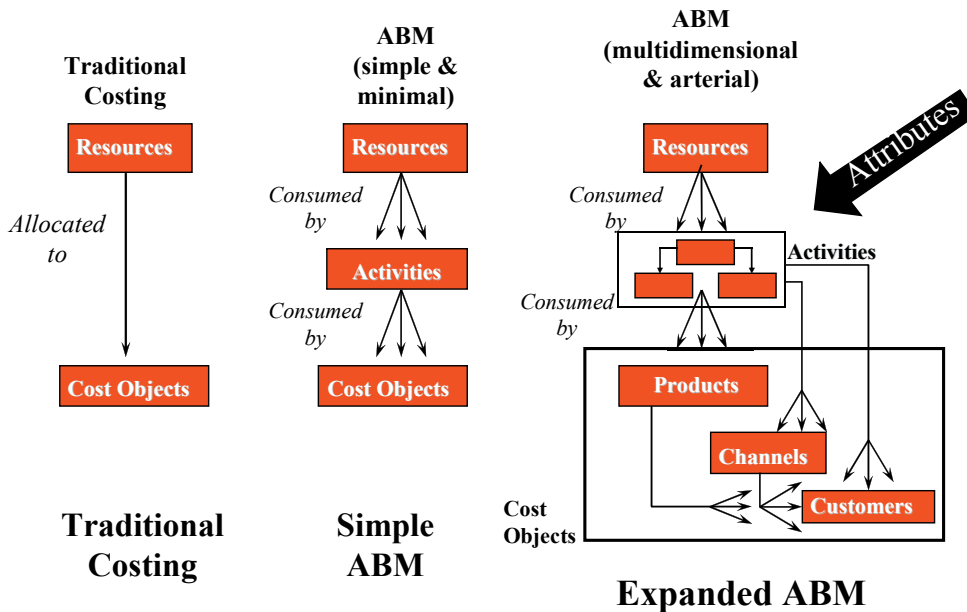
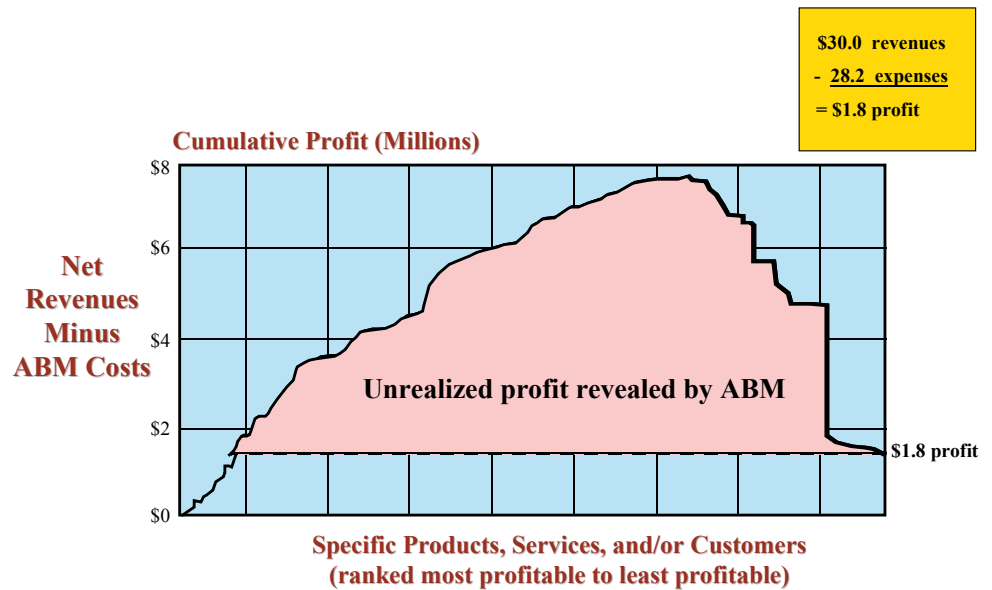


Figure A: Stages of maturity of cost accounting methods

ABM provides the finer level of granularity and also the architecture of multistage cost assignment paths. With ABM there are activity-to-activity assignments among indirect and support costs, because all indirect activity costs cannot directly reflect variation caused by products or customers. There are also cost object-to-cost object assignments. An example of the latter assignment type is the cost to process a special transaction (versus a standard transaction) traced to a specific customer or a group of customers consuming a unique quantity and mix of products, services or outputs.

### A true picture of customer profitability

Profit margin math subtracts the true ABM product and service-line costs from the revenues. A profit margin is always a derivative – it is the money that is left over. With ABM, product and service-line costs shift from what managers believed them to be, while the price and volume do not shift but remain unchanged. As a result, the profit margins are also substantially different than the organization’s beliefs. This result is also due to the fact that margins are often thin, so even slight changes in costs make a large difference in profits. Figure B is a graph of how unrealized profits can be hidden due to inadequate cost allocation methods. The graph, often referred to as a profit cliff, displays the result of the cost subtracted from income each customer – accumulated from the most to least profitable customer.



13

**Figure B: Profitability profile using ABM**

The graph reveals that roughly \$8 million of unrealized profits came from the most profitable three-fourths of a company’s products and/or customers and roughly \$6 million was lost on the remainder. This can be organizationally shocking to the senior management team. For some companies the graph’s ‘peak point’ is much further to the left, meaning it makes most of its profits on only a small fraction of its products and/or customers. What can management do?

In addition to the list of options earlier mentioned, because ABM can measure the costs of the output of processes as part of its product and customer cost calculation, this cost data can be leveraged. The data provides visibility to the cost of work activities consumed. It can be used to drive productivity and better asset utilization. Most organizations have very little insight about their outputs; not about the obvious products and standard service-lines that they deliver to end customers, but rather about the internal “outputs” of the work done in their organizations—the so-called hidden costs. For example, internal outputs reflect the work effort and cost to generate:

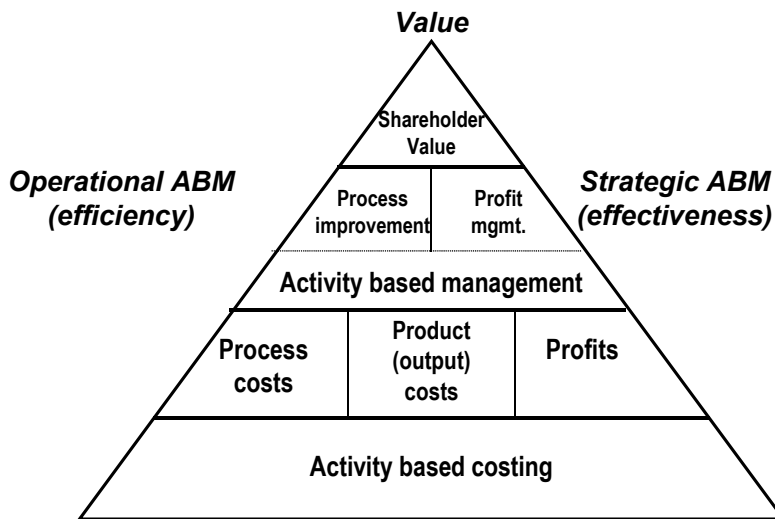
- A newly enrolled account.
- A processed invoice.
- A processed customer complaint.
- A completed new customer sign-up.
- A completed executive report.
- A customer sales call.



These examples are not the “work activities” that employees perform. They are descriptions of the results after the activities have been performed; in other words, they are the outputs of work. A collection of outputs leads to “outcomes”—products, services and the like—a more macro result for which ABM can also calculate the cost. When unit costs are trended or compared with other unit costs, then employees and managers gain more insight and act on their conclusions. They can benchmark to deduce if they might have a best or worst practice. ABM’s per-unit-of-each costs can also be included as key performance indicators (KPIs) in the organization’s balanced scorecard.

**The “M” in ABM**

Figure C illustrates how activity-based costing data provides a solid base for strategic ABM (i.e., doing the right things—effectiveness) and for operational ABM (i.e., doing them well—efficiency). In the lower level of the pyramid, ABC transforms transactional data into meaningful information for discovery and insights about process costs and product/channel/customer costs for measuring profit margins. Moving up the pyramid, ABM then puts the activity-based costing information to use with analytic horsepower.



**Figure C: ABM drives BPM**

Equipped with ABM information for both planning and subsequent feedback, a company can monitor its performance by means of a balanced scorecard for accomplishing the initiatives and managing the processes that support its strategic objectives. Strategy maps, scorecards and ABM are foundational for business performance management.

ABM makes scorecard KPIs easier to populate with reliable fact-based information. This is because ABM already has accurate costs and in a format designed for decision support. Some organizations have initially designed their balanced scorecards without much cost data. Adding ABM information drives better business performance.

With the visibility created by ABM, organizations can identify where to remove waste, low value-adding costs and unused capacity. For example, a major executive jet aircraft manufacturer that measures their cost of quality using commercial ABM software's powerful attributing functionality has combined ABM with its Six Sigma initiatives. This is an example where the integration of tools and methodologies once performed independently leads to a more full vision of business performance management.

Cost driver analysis from ABM improves productivity. In a sense, the term "cost management" is an oxymoron because an organization does not really control its costs but rather it should manage what causes its costs to occur. By reducing the quantity, frequency or intensity of its cost drivers, the expenses can eventually be reduced.

Some perceive ABM as just another way to spin financial data. In the past, an ABM project was just that: a project that could not or would not be used as a repeatable and reliable reporting system. In those days, ABM would help fix a particular problem and then be ended. Practitioners now, however, view ABM as a source for useful, mission-critical managerial information that is essential for good decision making. Organizations will increasingly require valid ABM data to manage its existing customers to higher profitability and to attract new and profitable customers.





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