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A Balanced Scorecard Approach To Measure Customer Profitability

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The Balanced Scorecard introduced customer metrics into performance management systems. Scorecards feature all manner of wonderful objectives relating to the customer value proposition and customer outcome metrics—for example, market share, account share, acquisition, satisfaction, and retention.

Yet amid all these measures of customer success, some companies lose sight of the ultimate objective: to make a profit from selling products and services. In their zeal to delight customers, these companies actually lose money with them. They become customer-obsessed rather than customer-focused. When the customer says "jump," they ask "how high?" They offer additional product features and services to their customers, but fail to receive prices that cover the costs for these additional features and services. How can companies avoid this situation? By adding a metric that summarizes customer profitability.

Consider the situation faced in the 1990s by one of the nation's largest distributors of medical and surgical supplies. In five years, sales had more than tripled to nearly $3 billion, yet selling, general, and administrative (SG&A) expenses, thought by many to be a fixed cost, had increased even faster than sales. Despite the tripling in sales, margins had declined by one percentage point and the company had just incurred its first loss in decades. Rather than SG&A costs being fixed or even variable, these costs had become "super-variable."

The experience of this company is hardly unique. Companies often capture additional business by offering more services. The list is wide-ranging: product or service customization; small order quantities; special packaging; expedited and just-in-time delivery; substantial pre-sales support from marketing, technical, and sales resources; extra post-sales support for installation, training, warranty, and field service; and liberal payment terms. While all of these services create value and loyalty among customers, none of them come for free. For a differentiated customer intimacy strategy to succeed, the value created by the differentiation—measured by higher margins and higher sales volumes—has to exceed the cost of creating and delivering customized features and services.

Unfortunately, many companies cannot accurately decompose their aggregate marketing, distribution, technical, service, and administrative costs into the cost of serving individual customers. Either they treat all such costs as fixed-period costs and don't drive them to the customer level, or they use high-level, inaccurate methods, such as allocating a flat percentage of sales revenue to each customer to cover "below-the-line" indirect expenses.

The remedy to this situation is to apply activity-based costing (ABC) to accurately assign an organization's indirect expenses to customers. Many companies, however, have tried ABC at some time during the past twenty years and abandoned it because it did not capture the complexity of their operations, took too long to implement, and was too expensive to build and maintain. Fortunately, a new approach is now available that is far simpler and much more powerful than traditional ABC.

"Time-driven" ABC, introduced in a recent *Harvard Business Review*,1 requires obtaining information on only two parameters: the cost per hour of each group of resources performing work, such as a customer support department; and the unit times spent on these resources by specific activities for products, services, and customers. For example, if a customer support department has a cost of $70 per hour, and a particular transaction for a customer takes 24 minutes (0.4 hours), the cost of this transaction for this customer is $28. The approach has been successfully applied in more than 100 organizations and readily scales up even to companies with hundreds of thousands of products and services, dozens of operating departments, and thousands of customers. The end result is the ability to measure individual customer profitability accurately and in a system that is easy to implement and inexpensive to maintain and update.

The payoff: BSC customer profitability metrics

The ability to measure profitability at the individual customer level allows companies to consider new customer profitability metrics such as "percentage of unprofitable customers," or "dollars lost in unprofitable customer relationships." Such customer profitability measures provide a valuable signal that satisfaction, retention, and growth in customer relationships are desirable only if these relationships contribute to higher, not lower, profits.

BSC customer profitability metrics are also highly actionable. If a company finds that an important customer is unprofitable, it should first look internally to see how it can improve its internal processes to lower the cost-to-serve. After all, we can't expect customers to pay for our inefficiencies. For example, if important customers are migrating to smaller order sizes, the company can focus on reducing setup and order handling costs. The company can ask the customer to use electronic channels, such as Electronic Data Interchange (EDI) and the Internet, that greatly lower the cost of processing large quantities of small customer orders.

Customized pricing policies should be at the heart of any strategy to manage customer profitability. The company can set a base price for a standard product or service, with standard packaging, delivery, and payment. The company also provides customers with a menu of options representing variations from the standard order, such as a customized product or service, special packaging, expedited delivery, or extended credit terms. Each menu item has a price that at least cover its cost, as measured by the ABC model, so the company no longer suffers losses from offering customized services. The menu prices also motivate customers to shift their purchasing and delivery patterns in ways that lower total costs to the benefit of both the company and its customers.

Finally, perhaps a customer is unprofitable because it is purchasing only a single service. As an alternative to raising the price for this single service, the company can encourage the customer to purchase a wider range of services, expecting that the margin from a comprehensive set of services will transform the customer into a profitable relationship.

Figure 1 shows how one insurance company managed its customer relationships once it understood its full costs of serving them. It ranked customers on the horizontal axis, from most profitable to least profitable (loss). The vertical axis represents cumulative customer profitability. The shape of the curve in Figure 1 occurs in virtually every customer profitability study ever done, in which 15 percent to 20 percent of the customers generate 100 percent (or more) of the profits. In this case, the most profitable

40 percent of customers generate 130 percent of annual profits; the middle 55 percent of customers break even, and the least profitable 5 percent of customers incur losses equal to 30 percent of annual profits. With its most profitable customers, the company worked harder to ensure their continued loyalty and to generate more business from them. For customers in the middle break-even group, it would improve its processes to lower its cost of serving them. It focused most of its attention on the 5 percent-loss customers, taking actions to reprice services and asking them for more business in higher-margin product lines. If the company could not transform these customers into profitable ones by these actions, it was prepared to drop the accounts.

Customer profitability metrics provide a link, otherwise missing, between customer success and improved financial performance. Many companies have experienced profitless revenue growth. Scorecard measures of the incidence of unprofitable customers and the magnitude of losses from unprofitable relationships focus the organization on managing customers for profits, not just for sales—thus making the customer focus align with financial objectives.

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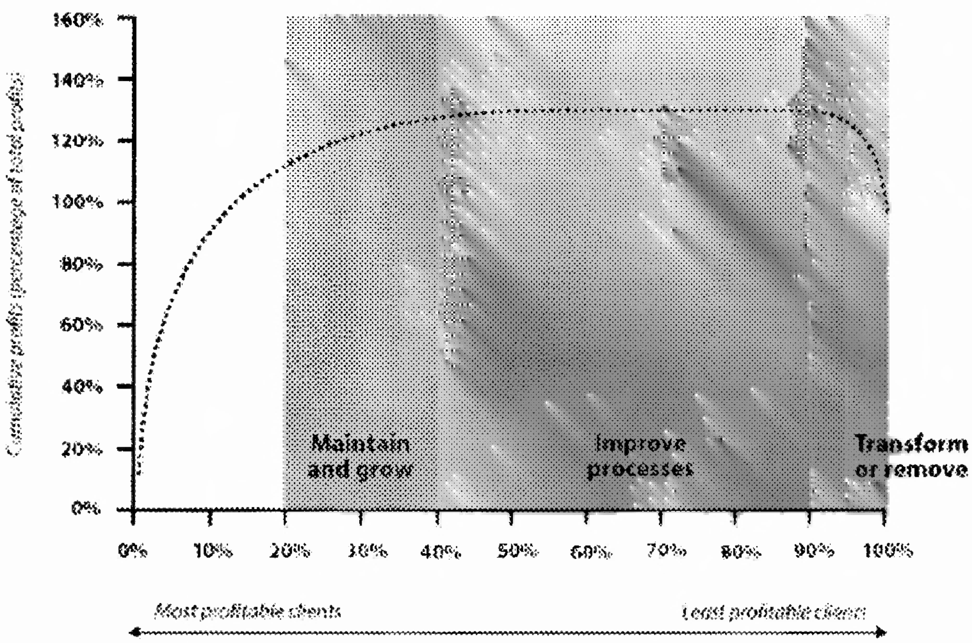
Footnotes:

1. R. S. Kaplan and S. Anderson, "Time-Driven Activity-Based Costing," *Harvard Business Review* (November 2004): 131–138.

Figure 1



About the author

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