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The Customer Profit Conundrum

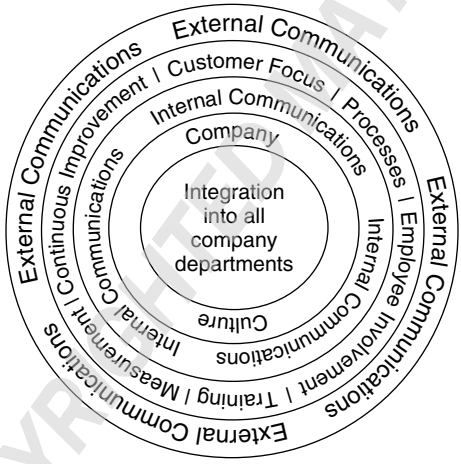


Figure 1.0 Customer management integration framework. © John A. Murphy 2005

One of the few things we can say with confidence about any company is that it will have customers. These customers do business with suppliers because they receive value and not because they want their suppliers to make a profit. The key question that needs to be answered is: 'Are all customers profitable?' Perhaps, even the question is wrong and it should really be: 'Are you making a profit from all of your customers?' The customer profit conundrum is the fact that very few

companies are able to measure individual customer profitability and so these questions cannot be answered.

Customer profitability is one of the most poorly understood concepts in business. Despite revived interest in the measurement of individual customer profitability, after a history of sporadic application and academic interest, there are no clear and robust methods commonly available for companies to follow. There is also confusion between customer profitability, customer lifetime value and customer economic profit, and the term 'customer equity' is sometimes applied indiscriminately between them.

The growth in customer relationship management (CRM) should have brought the customer profitability issue to the fore. There is little purpose in striving for stronger relationships with customers if they are actually unprofitable. Yet this point keeps getting missed from the agenda. Much has been written about recognising the lifetime value of customers, especially through the concepts of customer loyalty and customer equity. Most books and articles fail to recognise adequately the fundamental issue of true customer profitability, and many ignore this vital issue altogether.

Every organisation needs to decide who manages profits. Often, the day-to-day goals of departments, to increase output, reduce costs and keep customers satisfied, are only obliquely linked to profitability and do not allow action to be focused where it is actually needed.

The analysis of *individual* customer profitability opens a door on a new way of thinking about business. It provides routes to a clear strategy for profitable growth, which have previously been unavailable. This chapter outlines the key elements of customer profitability before providing a detailed technical methodology including a discussion of the management issues and with specific real examples of its use. It also highlights the fact that, for most companies, a large proportion of customers will be unprofitable.

Common misperceptions about customer profitability

Ask a company if it has unprofitable customers and you will usually get one of two responses: 'No, we don't have unprofitable customers', or,

'Ah, yes, 80% of our profit comes from 20% of our customers'. Even when a company acknowledges that it does have, or might have, unprofitable customers, it cannot readily identify which they are. The other misperception is that companies think that nothing can be done about unprofitable customers.

Challenging these misperceptions is the first hurdle in tackling the complex, yet critical, issue of customer profitability.

One of the most common rules of thumb in business is the 80:20 rule (otherwise known as Pareto's rule or law). This rule derived from Vilfredo Pareto's analysis of wealth distribution in nineteenth-century Italy, where he found that 80% of land was in the hands of 20% of landowners. Since then, it has been applied effectively in many contexts. For example, 80% of customer complaints come from 20% of reasons, 80% of production defects come from 20% of causes, and even 80% of revenues typically come from 20% of customers. Pareto is effective in so many situations that his formula has become accepted as an almost universal truth.

In the matter of profits, the rule does not necessarily apply. Using it, one might argue that, if 80% of profits come from 20% of customers, then 20% of profits come from the remaining 80% of customers, on the basis that all customers must be profitable.

Consider the most extreme example of a loss-making company. This will still typically have a range of customer revenues, which may well approximate to a Pareto-type distribution, but all of its customers are unprofitable, on average, since it is still making a loss overall. This is because of the nature of profit, where, although it is not possible to own a negative amount of land, it is possible to have a negative profit, i.e. a loss.

The flaw of averages

For a profit-making company, the common assumption is that all customers are profitable. In order to test this hypothesis further it is useful to introduce portfolios.

The idea of a portfolio is useful when dealing with a range of similar yet distinct profit-making assets; for example, a portfolio of shares, or a portfolio of business units. Figures 1.1(a) and (b) show the range of returns for a portfolio of business units and a portfolio of shares.

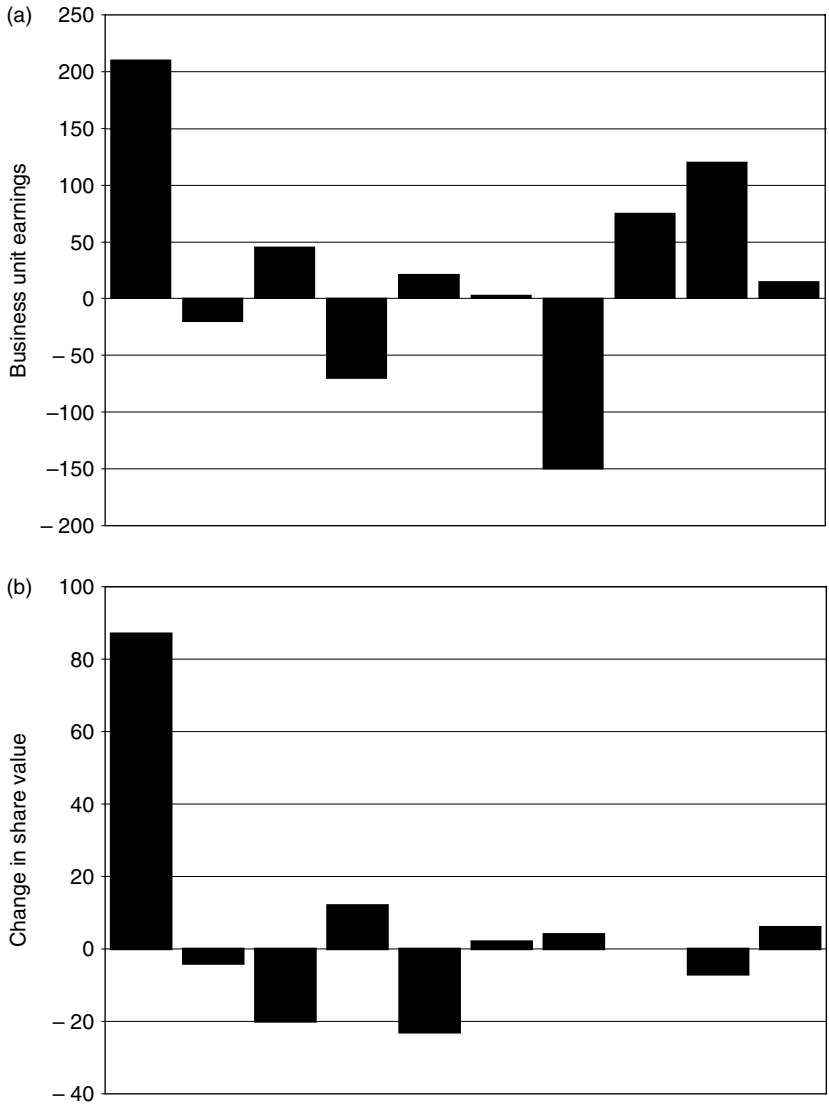


Figure 1.1 (a) Business unit portfolio returns (£M). (b) Share portfolio returns (%)

It is easy to comprehend that there can be losses within a portfolio, despite an overall gain from it. However, it would be meaningless to state that in Figure 1.1(a) the average return on each business unit is £5.7 million, or in Figure 1.1(b) the average return on each share is 24.9%. Using average returns does not allow changes to be made to improve overall profitability, nor does it assist with the selection of future new business units or shares. Yet this is precisely how most businesses deal with their customer base. By failing to recognise the issue of customer profitability, companies fail to recognise that, despite a healthy bottom line, there can be a considerable number of unprofitable customers within their customer portfolio. This is the flaw of averages.

The analysis of individual customer profitability will typically reveal that a company is servicing a proportion of unprofitable customers. This proportion can be significant, in many cases over 50% of the customer base. This leads to some startling results, which are contrary to Pareto's formula, and seem to challenge basic mathematics. For example, it is common to find that 20% of customers actually provide well over 100% of profits, with the remaining 80% causing a loss. So, where 20% of customers provide 200% of potential profits (a not uncommon finding), the remaining 80% of customers provide minus 100% of profits, in other words, a loss equal to 100% of the profits. This finding should have profound consequences on the way that a business is run and yet it often gets overlooked.

Misperceptions about Pareto and the use of flawed averages mean that companies fail to understand the spread of customer profitability. When customer profitability distribution is properly calculated, we enter the world of hyper-Pareto, where levels of profit concentration are even higher than 80:20.

Customer profitability analysis (CPA) should become a core discipline for all firms.

A definition of customer profitability analysis: the allocation of costs and revenues to specific customers over a specific period with the aim of measuring individual customer profitability.

There are other definitions in use, including that of the Chartered Institute of Management Accounting (CIMA), which defines customer profitability analysis as the 'analysis of the revenue streams and service costs associated with specific customers or customer groups'.

Customer profitability analysis enables a company to gain an understanding of the drivers of individual customer profit, and to take practical and focused steps to improve overall profitability performance.

An overview of customer profitability analysis

The measurement of customer profitability requires a combination of accounting and marketing skills that is often lacking within a firm, due to compartmentalisation of the business.

The relevance of management accounting to strategic decision making has been covered in other books, however, before discussing customer profitability, it is important to understand why most commonly used management accounting conventions do not provide the right information to allow individual customer profitability to be measured.

According to Johnson and Kaplan (1991) it was recognised almost 100 years ago that indirect costs could represent more than direct costs, and so, costing systems that primarily involved direct costs would be inaccurate at best and misleading at worst. Indirect costs have continued to increase for most businesses over the last 50 years, especially service businesses, making this discrepancy even more relevant.

Modern management accounting has been heavily influenced by the requirements of financial reporting, and this has led to an excessive emphasis on product costing, especially for the purpose of valuing stocks and work in progress. This does not allow companies to put together a clear picture of customer profitability. The power of modern information systems enables the analysis to be carried out more easily.

How to measure profit

Profit is typically measured using a Profit and Loss (P&L) statement (or income statement). The P&L represents one of the key annual

financial reports, and consists of several parts, each reflecting a different aspect of profit for a business, for example gross profit, trading profit, profit before interest and tax, profit for the financial year.

Basically, a P&L covers the following:

Total	**revenue, turnover** or **income**
Less	cost of sales (cost of goods sold)
Equals	**gross profit**

Total	**gross profit**
Less	other expenses (operating expenses)
Equals	**trading profit** or **net income**

The cost of sales (cost of goods sold) typically contains only direct costs, and so, for a retailer, this would be the actual wholesale cost of the goods sold. The costs in other expenses comprise a range of costs with different characteristics. These include direct and indirect (or overhead) costs such as lighting, insurance etc., which can represent fixed or variable costs, together with some non-cash costs. Depreciation is the main non-cash cost, in that it is a way of accounting for capital consumption over the lifetime of an asset. These costs are drawn together into the other expenses category for the purpose of reporting overall financial performance in the trading profit.

Behind these financial statements there will be management accounting systems to assist with the day-to-day running of the business and decision making about its future. However, management accounting systems have evolved in a way that often masks information about individual customer profitability.

Model financial statements, such as those from Deloitte Touche, break down other expenses into the following categories:

- distribution costs;
- administrative expenses;
- other operating expenses.

There are no clear distinctions between these groups, which are often referred to as sales, general and administration, or even sales, marketing,

distribution and administration (SMDA) costs. There are no generally recognised definitions for these categories, and the only proviso for financial reporting is that a company must be consistent in its definition of 'administrative expenses', 'cost of sales' and 'distribution costs'.

Since many of the below-the-line costs relate to customer relationships by way of sales, marketing, distribution and administration, customer profitability becomes a key strategic factor for organisations to consider. The proportion of these costs to individual customers is difficult to extract from financial statements and from management accounting systems. The allocation of these so-called other expenses to customers is, however, the key part of the calculation of individual customer profitability.

The nature of customer costs

If all customer costs were variable and varied in direct proportion to sales, it might be argued that all customers could be profitable. However, there are fixed costs and costs that are independent of the level of sales in every company. When these are taken into consideration, the question of individual customer profitability becomes even more important, and yet it seems even more opaque.

Many companies find that some customer-related costs are actually super-variable, that is, they increase at a faster rate than sales. This can have a dramatic impact on customer profitability and underlines the need to measure customer profitability.

The accurate allocation of SMDA costs directly to individual customers is key for the calculation of individual customer profitability.

Operationally, all businesses have a hierarchy of customer-related costs:

- product costs (usually direct and often called cost of goods);
- selling costs;
- servicing costs;
- relationship costs;
- business-sustaining costs.

These are shown in Table 1.1 together with some examples.

Table 1.1 The customer cost hierarchy

Product costs	Selling costs	Servicing costs	Relationship costs	Business-sustaining costs
Cost of goods	Sales and marketing	Distribution, administration	Sales and marketing, administration	Administration
Direct costs of product e.g. materials, packaging	Customer acquisition cost Advertising	Cost-to-serve Order processing, shipping etc.	Account management, administration, hospitality, CRM systems	Senior management, premises, R&D

Usually, only the product (or service) cost is considered in the measurement of gross profit. All of the other costs are lumped together below gross profit, to allow the measurement of trading profit. Clearly, many of these costs are linked to the servicing of individual customers, and yet there is no formal mechanism to measure individual customer profitability.

To illustrate this, consider a range of typical customer-related costs for a consumer product. First, there are customer acquisition costs; these include the costs of marketing campaigns in their widest sense: market research, advertising, promotion and channel costs (including incentives and discounts).

Secondly, there are the costs to serve the customer, including order taking, order processing, inventory management and customer-order fulfilment costs. Customer-order fulfilment includes product storage, picking, packaging and distribution. Behind this there will also be the cost of processing the financial aspects of the transaction: collecting and banking payment. Post-sales customer service might also include technical support, returns and complaint handling.

Thirdly, there are relationship costs: examples of which include running user groups, newsletters, web chat-rooms, CRM systems and so on.

Finally, there are business-sustaining costs, which often represent the entry-level for the business: head office, investor relations, human resources management, finance, insurance costs and so on.

In each case mentioned above the behaviour of the company and of the customer can influence the real level of individual customer profitability.

Before going into the detailed method for CPA a consideration of some basic information that can be gleaned from a P&L statement (Figure 1.2) will help to illustrate the reasons for doing a detailed analysis.

Figure 1.2 represents a 6.36% return on sales revenue. The key question is does every pound of revenue yield just over 6 pence of profit?

The revenue figure shown is in fact the sum of revenues from each customer. The costs of goods sold will often be in direct proportion to the revenue from each customer. The key question is how to apportion indirect costs and overheads. This has troubled accountants since the earliest days of commerce.

Having accepted that it is difficult to discover how to apportion these costs to individual customers, it is possible to utilise some basic facts that can be extracted from the P&L if we know the total number of customers, in order to question assumptions about the profitability of customers.

Using Figure 1.2, and assuming that there are 250 customers, we can do some very basic analysis.

Revenue

The average revenue per customer is £22,229. However, looking at the detailed breakdown of revenues from the customer base, the highest

Revenue	5,557,291
Costs of goods sold	2,111,771
Gross profit	3,445,520
Other expenses	3,083,389
Operating profit	362,131

Figure 1.2 Example of a profit and loss (P&L) statement

customer revenue is £210,724 and the lowest is just £16. In fact, when we look at the customer revenue data, we find that 80% of revenue comes from approximately 40% of customers.

Gross profit

The average gross profit per customer reveals an interesting 'flaw of averages'. The average gross profit per customer is £13,782. Since it was established that the smallest customer generates just £16 revenue, the flaw is immediately obvious. It is also important to recognise that 187 customers (out of the 250 in this case) actually generated revenue of less than the average gross profit.

Overheads

In allocating overheads to customers, the most common method used is to allocate the overhead in proportion to each customer's revenue, as a percentage of total revenue. This means that the largest customer, who contributes 3.89% of revenues, will also attract 3.89% of overheads. This is equivalent to £119,944 whereas the smallest customer, with revenue of just £16 or 0.0000028% of revenues, attracts just £8.63 in overheads.

The question to be asked is what are the reasons for the overhead being incurred? Is it reasonable for just £8.63 to be the cost of serving the smallest customer? The average overhead per customer is actually £12,334 and is probably nearer the true cost to serve each and every customer.

Customer profitability analysis (CPA) and activity-based costing (ABC)

Customer profitability analysis is often confused with activity-based costing because they are based on the same basic concept, identifying

the drivers of cost. However, the fundamental frame of reference for each is different. Both approaches trace or apportion overheads to a cost-driver, but for ABC these costs are typically product-related, and for CPA these costs are customer-related.

With ABC, it is common to find that a high percentage of products, when fully costed, are being sold at a loss. Efforts can then be made to reduce this loss, or to cease production of certain products. This assumes that all products can be sold at a profit, and fails to take the needs of customers into account.

There have been cases where companies have shed unprofitable parts of their product portfolio, only to find that their customers leave. This is because customers want to purchase a related range of goods, not just the few that the supplier thinks can be sold profitably. A commonly encountered analogy is that of a supermarket, where staple goods, such as milk and bread, are often sold at a loss to provide an incentive for the purchase of a more comprehensive basket of goods. The supermarkets aim to make a profit on the customer, not on each product. If a supermarket carried out a product-focused profitability analysis and, on finding these products unprofitable, decided to withdraw milk and bread, it would soon find itself failing to meet the needs of its customers. This can be true for all businesses, not just supermarkets.

Activity-based costing has also been the traditional domain of manufacturing companies, and it has not always recognised the needs of service businesses, where a far greater proportion of costs is indirect. New time-based methods for ABC make this easier.

It is interesting, when considering ABC and CPA, to examine the influences on individual product or customer profitability. For ABC and products, the reference is often what the company does, whereas for CPA and customers the reference is often how the customer behaves. By examining customer needs and behaviour, it becomes possible to develop a wider and more sustainable understanding of how to grow the business profitably.

So, although the methods used for ABC and CPA have many similarities, there are critical and fundamental differences in their application.

Where is CPA appropriate?

CPA is relevant to all businesses as a strategic issue. There are, however, several factors that will influence the approach taken to measuring it. These factors include the:

- availability of customer information;
- number of customers served;
- variation in customer spend.

Availability of customer information means having the ability to recognise individual customers and their attendant revenues. This is seldom a problem in the business-to-business (B2B) context, and there are also many business-to-consumer (B2C) companies that have access to specific, individualised customer data, including airlines, telecommunications providers, banks and insurance companies. Having access to individual data, and assuming it can be scaled up from transactions to get a total customer view, is the key to making a detailed customer profitability analysis.

Where there is no individual customer data, it will still be possible to carry out a basic CPA, using customer modelling around behavioural analysis. The rise of loyalty cards has been one of the main ways in which companies have tried to get more information about their customers.

Similarly, the number of customers served can affect the approach taken to CPA. With up to 5000 customers it is possible to use a basic spreadsheet to do the analysis, and most cost categories can be analysed to an individual level. Above this level, companies often tend to use agglomerations of customers to enable the reporting of results in decile or quintile blocks.

Finally, the level of variation in revenues from customers also makes a difference. Where customer revenues are very similar, it might be perceived that there is very little use for CPA. This might be true, but experience shows that it is always worth examining customer profitability. Single-sized pricing generally means that some customers will be underserved, and an opportunity is being missed, while others will be

being overserved, receiving services that they do not need, want or value.

These factors might influence the way in which the analysis is carried out, or the way the results are used, but CPA is relevant for B2B and B2C companies, with high or low growth, mature or start-up, and regardless of the number of customers.

Online versus off-line analysis

Historical data for the previous year, so-called off-line data, normally forms the basis for the analysis. Most companies use this as a starting point for their CPA. A year is a normal analysis period, smoothing any seasonal fluctuation, but where this is not a factor, smaller periods, like six or three months, could also be analysed.

The alternative approach is to develop an online model, whereby cost elements are allocated to customers on a per activity basis, as incurred, to give a current picture of customer profitability. This data, although current, can only be of real use if it is summarised for a relevant period, however, and this is usually an accounting year.

Companies should begin with off-line analysis of historical data because it takes time to be comfortable with the approach used and historical data is readily available. Once the benefits and power of CPA have been recognised, it will be possible to move to a live, online system. There are vendors of online analytical tools for the measurement of customer profitability; they do not always measure the true level of individual customer profit, but often focus on gross profit.

How to measure individual customer profitability

There are no standard recognised methods for CPA. While the basic concept is simple: to subtract customer costs from customer revenues in order to identify customer profitability, complexity

arises because there are many types of costs: direct, indirect, fixed, variable and so on.

Companies often evolve their own approaches in practice, but the fact that different approaches provide very different results should be of concern to anyone trying to measure genuine customer profitability.

The different CPA methods used in practice

CPA methods range from broad and simple methods based on using percentages of sales to allocate costs, through to intricate allocation methods based on those actual activities that incurred the costs. We have encountered a variety of methodologies, including:

- gross profit contribution;
- partial overhead allocation (some overheads allocated in proportion to revenue, or even activity);
- customer-related cost allocation (bringing sales costs and relationship costs, for example);
- full allocation (even tracing) of customer costs.

There are also industry-specific approximation methods, such as Federal Reserve Board functional cost analysis figures as used in the US banking industry.

However, these methods all give very different results, and care should be taken about the appropriateness of each method, especially when the conclusion is to sack some customers. It is important that the more detailed methods are used because, when it comes to migrating unprofitable customers, it is essential to understand the reasons for the lack of profitability. This cannot be done effectively if only the gross margin contribution is known. A key point raised with regard to costs at the basic level is that, for large customers, overhead costs are generally overallocated, and for smaller customers they are generally underallocated.

However, whichever method is used for the analysis, the process and discipline of carrying out CPA will stimulate a customer

profitability mindset, which can lead to positive results being achieved. This would suggest that the specific method is less important than the fact of actually carrying it out.

The customer profitability paradigm usually represents a revolution in thinking for most companies and, therefore, it is difficult to accommodate this by simply evolving current systems.

A step-by-step approach to measuring customer profitability

The basic equation for customer profitability analysis is:

Customer profitability = Customer revenue − Customer-related cost

Within the customer-related cost lie several levels of cost, and these will be broken down in the following sections. Before discussing costs, it is actually necessary to begin with a discussion of the measurement of individual customer revenues.

Individual customer revenues

Identifying individual customer revenues is the most straightforward part of customer profitability measurement. Customer transaction data should be readily available in the sales ledger, and need to be combined at the individual customer level. There are some issues commonly encountered here, including the problem of duplicate data, the issue of multiple sites for the same customer, and adjustments to revenue from the use of credit notes, for example. Finally, since CPA can be completed for a company, division or subsidiary, regional business unit, or specific channel, care should be taken to ensure a complete view of the customer, what the customer spent, and its strategic significance for other divisions of the company. What could

be an unprofitable customer for one department could be a highly profitable customer for another.

Duplicate data will typically affect a very small percentage of customer records but should not be ignored. Customers can be included more than once into a database for a range of reasons, even due to the name of the person placing the order. Data cleansing to remove duplicates should be carried out in order to minimise the impact of this.

The issue of multiple sites potentially within the control of the same customer can pose a more serious problem. For example, a single customer with small expenditure at multiple sites could represent a significant amount of revenue overall. The best approach is to treat transactions individually to begin with and then to combine them, as appropriate. This is because there are transaction level costs, so it might be important to recognise the number of transactions that each customer has undertaken.

It is also important to reconcile the total customer revenue with any credit notes, discounts or rebates, especially if applied retrospectively, based on volume, for example.

Individual customer gross profit

Having identified the revenues from customers, the next step is to calculate the customer gross profit. The starting point is to determine the direct costs of the different types of products or services the company has purchased. Some of this detail is obtainable from a company's stock purchase orders or invoices. The more complex the company's product or service basket the more time will need to be spent collating the data. Although this may be time-consuming, it is easily done. It might also be necessary to begin the process of CPA with a consideration of the accuracy of product costs. These are the costs of products or services that can be attributed directly to products, and could include materials and packaging, for example.

Customer gross profit = Customer revenue – Cost of goods sold

The starting point for profitability analysis should be to gain a clear understanding of product or service costs; particularly important when a company has a wide range of products. Activity-based costing can be used to assign the costs of activities and resources to those products that incur them. Incorrect cost allocation leads to ineffective pricing, where some products might be being sold at a loss.

Whichever method is used, the aim is to get a value for the gross profit on each customer's revenues.

Allocating other expenses to individual customers

The complex part of individual CPA is usually in understanding and measuring all the other expenses cost-related to individual customers. These costs are in many layers, like an onionskin. The term DACCs, or directly attributable customer costs, is sometimes used to describe these costs.

The full customer cost-to-serve model should include:

- selling costs; (customer acquisition costs)
- servicing or processing costs;
- relationship costs (essentially customer retention costs);
- business-sustaining costs (costs of being in business but not doing business).

Examples of each of these are given in Table 1.2, followed by a detailed discussion of each of the items together with the approaches used to measure them.

Selling costs

If a business has been operating for a long period, the majority of its customers will not have been acquired in the year under consideration. Typical customer acquisition rates, as a percentage of the existing customer base, are often between 2 and 10%, except for very high growth companies. Selling costs can therefore be considered to be zero

Table 1.2 Directly attributable customer costs

Selling costs	Servicing costs	Relationship costs	Business-sustaining costs
Advertising, sales force, promotions	Order processing, shipping, installation etc.	Account management, administration, hospitality, CRM systems etc.	Offices, senior management, insurance, audit, R&D, premises etc.

for the majority of customers. This is not to say that costs from the sales and marketing functions, such as key account management etc., will not have been incurred but simply recognises that these costs are actually part of the relationship cost. The selling costs associated with sales and marketing activities, including advertising, usually only apply to the acquisition of new customers.

The problem lies in the fact that companies seldom measure the different categories of customer very well. Some companies have no idea how many customers they have for each product or service they offer. This is because there are different types of customer:

- customers served in the last 12 months (this time scale is arbitrary since a relationship could have a longer natural period than 12 months, for example a 3-year capital expenditure cycle);
- customers who have lapsed after making a purchase;
- prospective customers;
- target customers.

CPA is usually only concerned with the number of customers served in the last 12 months, and within this group it is important to recognise the actual number of customers that have been acquired in the period.

Companies often do not dare to measure the total selling cost, nor do they compare it against the number of customers acquired in the same period. This is usually because of fears of low measurable impact.

When the number of new customers acquired in a period is measured, it can be a pitifully low figure. Many promotional offers that were aimed at acquiring new customers fail to win new customers and give a discount to existing customers instead. At the height of the dotcom bubble, many companies' customer acquisition economics were so flawed that it was costing them more to acquire a customer than the expected lifetime value of the customer.

Where do selling costs go?

It was John Wannamaker who first said, 'I know half the money I spend on advertising is wasted, but I can never find out which half.' This is still true for most organisations, and is one of the biggest obstacles to CPA. Of course, it is essential to recognise the complex nature of advertising and the fact that it is not always designed to generate sales. It is also possible to develop the brand through advertising, or even to provide additional value to existing customers who bask in the glow of the brand value. But, the majority of advertising is about getting customers to buy. It might start with awareness, interest and desire, but it should end with action.

The other complicating factor is that it is hard to recognise the actual reason for a customer making a purchase. The real reason is likely to be a complicated cocktail of needs, adverts, word-of-mouth recommendation, previous experience and budget. However, if a company has managed to attract 1000 new customers and the total marketing and advertising budget was £1 million, then, however you dress it up, the net effect is an average spend of £1000 per customer.

There is also the matter of timing of customer acquisition and allowing for prospects that are just around the corner. For financial reporting, all costs incurred in the period have to be allocated to that period, regardless of whether they constitute an investment with a view to future cash flows. For simplicity, the same approach should be followed with selling costs.

However, it is possible to split selling costs into two categories: successful, that is linked to the acquisition of a customer, and unsuccessful, that is all other expenditure that could be considered to be a business-sustaining cost. The likely magnitude of this expenditure will cause questions to

be asked about the effectiveness of the sales conversion process. It is not just advertising costs, there is also the question of sales-force costs. These can be quite large, and examples of selling costs for a field sales force are:

- salaries and commission;
- car;
- laptop and communications;
- travel expenses;
- occupancy;
- home office allowance;
- medical and other insurance;
- taxes and national insurance;
- pension.

Since all of these costs are incurred to acquire new customers, they should be defrayed against those same customers. The issue of unprofitable customers will be dealt with later, but it is worth noting that many customers will be unprofitable in their first year of a relationship with a company due to their high costs of acquisition.

Other costs of acquisition include the costs of promotions and deals (for example, buy one get one free), which might represent reduced revenue together with any incurred costs for items such as a telephone handset or free gifts. Whichever costs are included in selling costs, the aim is to quantify the cost of acquisition of new customers in the period under analysis.

Servicing costs

The next level of costs is servicing costs which include the costs of key activities derived from customer requests – essentially customer fulfilment costs. They might include order processing, special packaging requirements and shipping costs. Examples of some typical servicing costs are shown in Figure 1.3.

Some companies evaluate a sample of customers to see the way in which servicing costs vary. Approximate costs per activity can then be allocated on a customer level. The majority of these will have two key cost drivers: the number of transactions and some customer-specific data, such as location of the customer.

- Balance and payment enquiries
- Change account details
- Change/Create price
- Copies of invoices and proof of delivery (POD)
- Debt management
- Delivery status
- General feedback and issues
- Invoice enquiries
- Order delivery and product collection/return
- Price enquiry
- Proactive price notification
- Product safety and technical data sheet request
- Product price quotation – spot
- Product returns
- Require promotional material/product
- Technical and product enquiries

Figure 1.3 Examples of typical customer servicing costs

There is a range of possible costs for the servicing cost that will depend on the product or service being offered. Key questions to ask at this stage are how does customer behaviour affect the level of servicing cost, are some customers over-served, getting more value than they need and how could company systems be changed to manage this more effectively?

Relationship costs

Relationship costs are those costs incurred while managing and developing the customer relationship. Often these costs are incurred at the discretion of the company rather than the customer, although individuals on a sales force might have the final discretion.

There is a wide range of activities that can be put into this category, including:

- management review of the customer account;
- face-to-face negotiations;
- joint promotions;
- industry forums;
- regular calls;

- industry newsletter update;
- price notification.

And it can involve a range of people, including key account managers, field sales staff and office-based staff, including telemarketers.

Sampling of data: sampled average versus total data

The key question that arises for relationship costs is whether to measure or analyse data for all customers with, for example, interviews with the entire sales force about their activities, or whether to take a sample. In addition, averages can be used for some smaller, attributable costs.

Sampling and the use of averages reduce the accuracy of the data but take less time and are perhaps more repeatable for future measurement. As with all management information, there is a trade-off between the cost to get the data and the benefit that will be provided from knowing it.

Business-sustaining costs

Business-sustaining costs are those incurred to keep the business running. Despite many of them not being able to be directly linked to individual customers, these costs must be covered by the overall net customer profit remaining after allowing for the cost to serve.

There is extensive debate over whether *all* overheads can or should be allocated to individual customers. The costs of IT, R&D and senior management are all incurred in trying to serve existing customers, or to acquire new customers, and yet many companies are reluctant to allocate them.

The arguments against allocation are often that the costs are fixed, or that they fit into the 'rule of one' that was developed as a rule of thumb for activity-based costing. This states that if there is only one managing director, for example, you shouldn't allocate his/her cost between different customers because, even if you reduced the number of customers, you will still need one managing director.

However, an analogy from voyage accounting for mercantile shipping is relevant here. After each voyage, all costs related to the voyage were deemed to have been incurred to fulfil the import of goods, and so all expenses were offset against the income generated by the goods. In a similar way it can be argued that all costs in the last year have been incurred either to acquire or to serve the existing customer base. There may be reasons why this is not reasonable: for example, with R&D for future product development, but some allowance of the cost has to be made in the current profit and loss.

The assumption is sometimes made that reducing the number of customers is the main action resulting from the analysis of customer profitability, and so fixed costs should not be included in the analysis since they will remain after customers have been sacked. As we shall discuss later, whilst sacking customers is a viable strategy after CPA, it is not its prime goal.

Final integration of cost data

The final stage in CPA is to combine the customer-related costs and to subtract these from the individual customer revenue in order to measure the individual customer profit, as shown below:

> Customer profitability = Customer revenue − (Cost of goods + Cost to sell + Cost to serve + Relationship cost + Business-sustaining cost)

Getting started with customer profitability analysis

The method outlined in this chapter is necessarily detailed and perhaps daunting to anyone setting out to measure customer profitability for the first time. There are some short cuts that can be taken to give an overview of the customer profitability issue.

1. Recognise that it is an issue. The company about to undertake CPA must be convinced that customer profitability is relevant. When a company is profitable, the commonly held belief is that all customers are profitable.
2. Use available data to create a simple model. This is best done by developing a simple process flow of customer interaction, to see where costs are incurred. The key data you will need are:

   – total revenue by customer (to include discounts/rebates and credit notes);
   – total business unit costs, especially overheads;
   – for each cost group (sales force, call centre, etc.) identify the drivers of costs.

3. For each customer, subtract from their total revenue their direct product or service costs (cost of goods sold/cost of sales) to obtain a customer gross margin. If you have a good understanding of your basic gross margin, for example, if prices are set to give a 45% gross profit, you can apply this to get a quick recognition of the customer gross profit contribution.
4. The key stage is to subtract other expenses or overhead costs. This can be done relatively quickly by:

   – focusing on significant activities and costs, allocating costs that can easily be identified and that are directly traceable to specific company/customer interactions, such as customer acquisition, servicing and retention costs. Tackle more ambiguous costs later;
   – use estimates where possible. They will not be 100% accurate but will provide a starting point. If it is apparent that the figure might have a significant impact on customer profitability, more accurate measurement can be made through the collection of additional data;
   – try to apply costs at the lowest possible activity level, to maintain maximum analytical flexibility, such as per transaction rather than per customer, to begin with. That way, they can be rolled up in many different ways;
   – determining customer profitability is not an exact science but a process. There will never be one correct number for a customer's profitability. Thus, the chief concern is not

pursuing the most precise measurement, but consistency in the application of cost-assignment methods.

5. Sort the customers in order of the net profitability and draw a cumulative profitability curve.
6. Before considering what to do with the unprofitable or less profitable customers, consider the company's reliance on key customers; see if there is anything in place to secure their future spend, and consider what can be done to ensure the continued relationship. This is essential and sounds logical but it is often overlooked.
7. Understand the reasons for unprofitable customers and consider whether anything can be done to increase their value to the company, before you decide to 'sack' them. Link the results to other applicable metrics, like life-time value, strategic significance etc. This is to ensure that you incorporate other factors, which call for the retention of unprofitable customers.

For those companies who, due to a variety of products or services and a wide range of homogeneous customers, feel that focusing on individual customers is impractical, there is an alternative. Customers with similar buying habits can be dealt with as groups. Careful segmentation of the customer base is a prerequisite of this approach. There is debate whether CPA should be done first, ignoring a company's current segmentation; or whether segmentation should be accepted as is and a CPA done on each particular segment. The argument for segmenting first is that a company's cost structure and processes will be very similar for particular segments, and it is easier to allocate costs in this way. In addition, for companies with a large number of customers, the amount of data that needs to be available and analysed in respect of individual customers makes the alternative approach impractical.

However, there are good reasons why CPA should be carried out before segmentation, as follows:

1. Each customer's behaviour may be different, even in similar segments, and the allocation of costs on a broad base (average allocation) provides a result that does not clearly show the associated cost impact per customer.

2. **The fact that costs are averaged makes it difficult to identify which customers' behaviour to modify; it is difficult to achieve when a company works with customer groups as opposed to individuals.**

If the barrier to analysis is the sheer number of customers, sample groups of customers can be selected, but cost allocation must still be done at the individual level. An alternative method to consider is that proposed by Peppers and Rogers (1997). They promote the use of lifetime value (LTV) to determine the ranking by profitability of customers, and suggest customer value tiered into groups such as quintiles. They propose identifying three different types of customer: most valuable customers (MVCs); second tier customers (STCs) and below-zero customers (BZs). They then recommend different strategic actions for each of these groups, including sacking of BZs.

Common barriers to customer profitability analysis

Many of the barriers and pitfalls to face when undertaking CPA can be avoided if they are anticipated.

There has been little clear guidance on the subject before now. One of the main barriers is a widespread lack of understanding of the methods used for CPA. It has prevented diffusion of knowledge from the CRM and customer management specialists. This leads to extensive denial of the fact that any customer could be unprofitable. This is often linked to a perceived lack of relevance to the organisation, since it is profitable overall.

Who actually manages profit? Surprisingly, it is the case that there is no one managing it directly, and this means that there is not always a clear leader for the analysis. The true cost to serve the customer is often regarded as just another shared overhead. There is reluctance to rock the boat on cost allocation, and this is especially true where it might also affect performance incentives.

Senior management buy-in is essential for any major project. Since CPA is a very broad analysis, it demands a high-level champion because it will require finance and marketing to talk to each other effectively. Also, resources will need to be made available for doing the initial analysis.

The perceived availability and accuracy of data and management information is another barrier to beginning CPA. However, most organisations will quickly discover that they have ample data to begin with in a range of different systems outside the main MIS. For example, sales force automation, customer contract systems, help desk and other systems. In fact, one barrier can actually be too much information. This can lead to paralysis by analysis. The lack of a clear methodology can lead some organisations to spend too much time chasing minute detail rather than getting an actionable ballpark figure.

Finally, a barrier for all new projects is 'initiative fatigue'. Companies are already swamped by other initiatives, such as six sigma, balanced scorecard, business excellence etc. Most of these actually have a specific customer dimension, which should be leveraged to ensure take-up. For example, where these initiatives talk about the voice of the customer, this could be replaced by the voice of the *profitable* customer.

Running a CPA project

The overarching context for carrying out CPA is to improve customer profitability in the short to medium term in a sustainable fashion. This can be done as part of a recovery strategy, or as an enhancement to current performance. It might also be part of a CRM system implementation project.

The commitment of senior management is critical to the success of any major project. This is especially true for CPA, since the nature of the changes that must follow is widespread, involving finance, marketing and sales personnel, and will often be of a strategic nature for the business.

It is essential to create a clear mandate for CPA with emphasis on *profit* not just revenue growth.

Whether or not external consultants are used to drive the process, it will usually be necessary to create a cross-functional team to implement the results. A team of people might need to be taken out of their day jobs and specifically dedicated to the project for its duration, to work alongside the consultants, if used. This team should comprise people from the finance and marketing sides of the business.

CPA can be seen as a dry and analytical subject, and many companies choose to brand the process, to make it more accessible to

staff and customers alike. It is good to choose a name with a positive connotation; rather than referring to it in terms of customer profitability, give it a working title, like Valuing Customers, for example.

One way of starting the CPA exercise is to carry out interviews at many levels within the organisation, to define the business case and to state the case for change. The case should be communicated face to face with all staff, with strong industry-specific metaphors being used by the senior manager, when stressing the need for swift and effective action to improve profits.

A brief session with a selection of sales, marketing and customer relations staff will also be of use and should provide some sound-bites that can be used to stimulate the project. The successes of the project should also be communicated widely within the company. Customers will get the message when the effects of CPA trickle through the company, and most companies do not communicate the nature and scope of the CPA exercise to their customers. What happens with CPA inside the company is not usually of much concern to the customer. If the project has significant potential to change the way customers are managed, it might be appropriate to inform customers about the project at some point. The message to customers should then be that the company is aiming to improve its customer fulfilment process.

During the initial CPA research, many companies will find that customers are receiving poor customer service when they are passed around the business, seeking resolution to problems and enquiries. This is time-consuming and expensive for the company, while being frustrating and offering poor service to the customer. One of the key lessons is to ensure that the service re-engineering process is effectively linked to a detailed service investigation, to ensure that service is enhanced where possible. Customers are generally positive and receptive to any efforts to improve service, providing service actually improves, and improvement is not just promised for some time in the future.

No specialist software package is necessary for CPA as a one-off exercise. The basic tools used are accounting systems (e.g. SAP or Sage), CRM systems, the Excel spreadsheet and the Access database. There are software systems that claim to run customer profitability, but they are often based on gross margin only, or on very limited and often averaged cost information. Others offer online analytical systems, but these should be used with caution, as the concept of 'real-time' profitability is highly nebulous. The paucity of clear and structured approaches to

CPA is one of the reasons for the lack of effective software. This book aims to provide, instead, a robust, yet customisable approach to the measurement of CPA.

It can take three to six months to gather and analyse customer profitability information. If CPA is to be used on an ongoing basis it is clear that there needs to be a transition from the initial analysis stage to the changed day-to-day management of the company.

The process of implementing changes as a result of CPA is a medium- to long-term one. The real benefits from changing the customer management process as a result of CPA will be achieved over a time-scale of approximately 12 months. This is because there are many areas that will need to be involved, including customer contact centres, the sales force and internal processes.

However, CPA does provide sufficient detailed information to allow quick wins to be identified, especially in relation to the targeted acquisition of new customers. Recognition of profitable customer types provides additional segmentation opportunities for the targeting of new customers relatively early in the analysis process. Migration of existing customers to profitability might require some investment but there will be a clear financial case for it.

It is advisable to create a team to develop ways of making the CPA approach part of the longer term culture of the company. In addition, the analysis could be carried out more frequently, such as on a monthly basis, with additional data being provided directly from sales force automation software and other CRM software. Relative profit values, not absolute values, are often used, for the ongoing measurement of profitability.

Post-CPA, there could still be some limitations to changing the customer response, due to the lack of detailed information being made available to front-line contact centre staff. Specific data requirements should be used to develop a blueprint for future CRM and financial systems.

The results of CPA

It is probably fair to say that every company has unprofitable customers. The results of CPA are often astonishing, and it is common to find initial widespread disbelief at the results. The initial reaction is to doubt the figures and question the methodology.

There are documented cases of companies where:

- 33% of customers give 125% of profits (with 67% of customers giving –25% of profits);
- 18% of customers give 600% of profits;
- 22% of customers give 250% of profits;
- 50% of customers give 150% of profits;
- 10% of customers give 320% of profits.

Without a detailed CPA, it is likely that any company will divert resources into unprofitable customer relationships and run the risk of disappointing a highly profitable customer.

Tools used to present results of CPA

There are two key diagrams used to display the results of CPA. These are the 'see-saw' as shown in Figure 1.4 and the 'whale curve' shown in Figure 1.5. Both diagrams display the profitability of customers from the most profitable to the least profitable. The see-saw displays individual customer profitability, from most profitable to least profitable, while the whale curve shows the cumulative profitability.

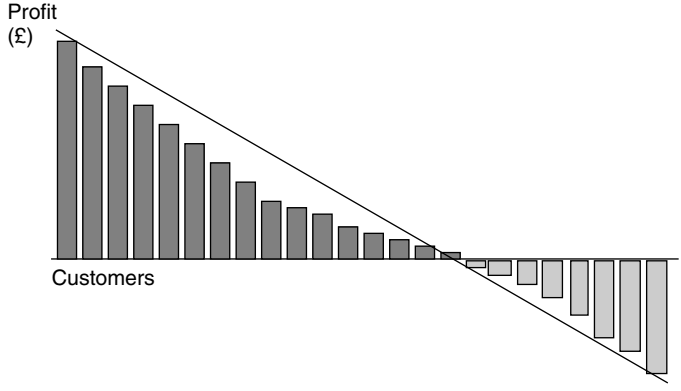


Figure 1.4 Presenting CPA results – the see-saw

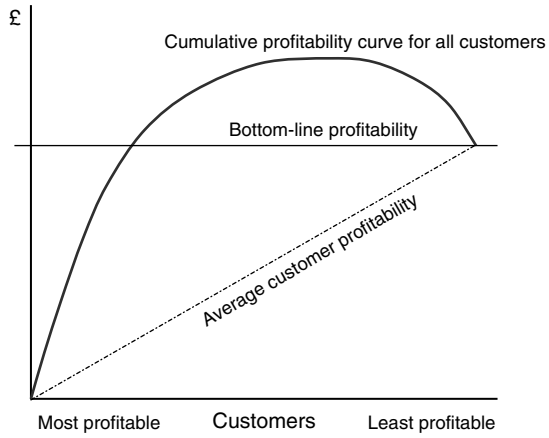


Figure 1.5 Presenting CPA results – the whale curve

The whale curve is useful to demonstrate graphically the varying profitability of individual clients, as it provides additional information of key relevance to the company.

First, since the graph is cumulative, it ends on the actual bottom-line profit figure. This provides a 'check and balance' to the analysis as well as giving a fixed point around which to consider the rest of the results.

Secondly, it is easy to see the impact of average profitability per customer as shown on the straight line from the origin to the final profit point.

The following points can be deduced from Figure 1.5.

- 60% of customers are profitable overall, 40% are unprofitable (60% profit-makers, 40% profit-takers).
- The 60% provide some 140% of profits, and the unprofitable 40% provide –40% of profits.

Why do companies have unprofitable customers?

Why do companies have unprofitable customers, since they clearly do not set out to acquire them? Instead of simply stating the apparent reasons for customers' lack of profitability:, small, unpredictable

orders, high distribution costs etc., it is important to recognise the organisational context in place for customer management. Companies have unprofitable customers because they fail to measure individual customer profitability, and as a consequence, they are unable to manage customer profitability.

The organisational context for customer management provides a variety of reasons for why and how companies acquire unprofitable customers. These are discussed below.

1. The sales force is continuously under pressure to close deals within a pricing range given to assist negotiations. They often chase volume, since this is how they are incentivised.
2. Pricing errors due to incorrect estimation of resource times, especially where job costing is applicable, because of a lack of recognition of the extent or complexity of the problem.
3. Companies put systems, structures and people in place that incorporate a 'one size fits all' approach, usually driven by economies of scale. Often, customers are unprofitable because they receive the same level of service and support as a more highly profitable customer, when their own level of business does not justify this. For example, same-day shipping on a small item, when the customer is not significant to the business.
4. Some companies provide products or services at cost or below, initially, with the intention to recover the initial costs and make more profit over the whole product life cycle. Sometimes profit does not materialise because customers switch, or anticipated long-term volumes do not materialise
5. Customer behaviour changes over time. Initial pricing of products and services does not allow for changes in customer behaviour. Usually, pricing is the competitive issue for negotiations. Companies will price initially based on expected average behaviour, and are unable to anticipate changes to individual customer behaviour. It can be that originally anticipated behaviour changes over time but these changes are not monitored and often become the norm. Changes in behaviour may result in substantial resource consumption through back-office activities, like order quantities, specific delivery and packaging requests, payment recovery etc. This change in customer behaviour is not usually followed by associated price increases.

These factors result in a disconnection between the customer revenue and the actual resources consumed. To remedy this situation, companies have to focus on restoring the connection between customers and costs. CPA is a key tool to help companies do this.

The actual reasons why customers can be unprofitable are manifold, and some of the main ones were listed by Robert S. Kaplan and Robin Cooper in their book *Cost and Effect*, Harvard Business School. Exhibit 10–4, p. 191. See Table 1.3.

Improving customer profitability

There are many specific actions with a clear benefit to the bottom line that can be developed as a result of completing CPA. These are typically wide ranging and involve cost savings, profit improvement,

Table 1.3 Why customers are unprofitable

High cost-to-serve customers	Low cost-to-serve customers
Order custom products	Order standard products
Small order quantities	High order quantities
Unpredictable order arrivals	Predictable order arrivals
Customised delivery	Standard delivery
Change delivery requirements	No changes in delivery requirements
Manual processing	Electronic processing (EDI)
Large amounts of pre-sales support (marketing, technical and sales resources)	Little to no pre-sales support (standard pricing and ordering)
Large amounts of post-sales support (installation, training, warranty, field service)	No post-sales support
Require company to hold inventory	Replenish as produced
Pay slowly (high accounts receivable)	Pay on time

performance improvement, better customer management and performance management etc. CPA provides a level of understanding about the business that other methods do not provide.

There is a misconception that the main outcome of CPA is the sacking of customers. This mindset perhaps arises from ABC, where many examples exist of companies reducing the number of products on offer as a result. However, sacking customers is the last resort and should only be considered when all else has failed. A customer in the hand is certainly worth two in the marketplace.

The first thought when confronted with a small proportion of highly profitable customers and a larger proportion of unprofitable ones should not be sacking. This is like looking through a telescope the wrong way. The wise company thinks about how to ensure that it can retain those highly profitable customers. It also seeks to improve the profitability of most of the rest.

Building on this, there are three core strategies that will be extensively influenced by the measurement of customer profitability. These are:

- customer acquisition;
- customer retention;
- customer development.

There are five levers that can be used to improve company profitability based on the results of CPA, which are part of the three core strategies. See Figure 1.6.

The first level is to reduce the cost to acquire new customers. This is done by using the most effective channels in terms of conversion efficiency and cost

The second lever is effective cross- and up-selling of products to your customer base. Cross-selling is one of the most powerful ways to improve profits. For a wide range of companies with tens of different product categories, the typical cross-product holding ratio is often just over 1–1.1 to 1.3 – showing that there is ample scope to improve.

The third lever is increasing the lifetime of your customer relationships by having effective customer retention plans in place.

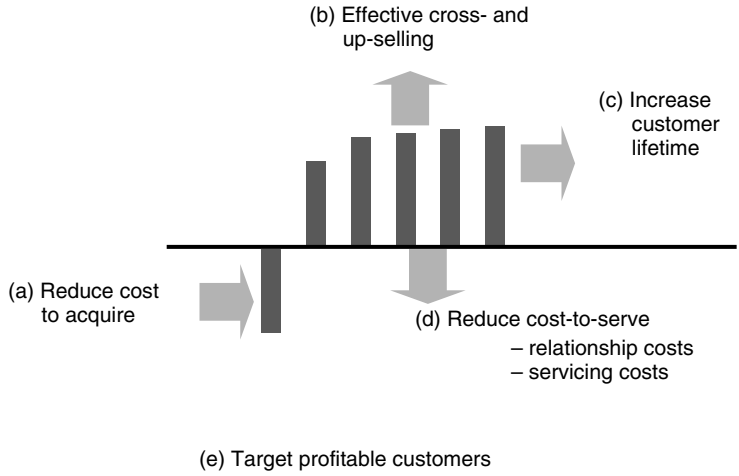


Figure 1.6 The basic levers of customer profitability. © KitshoffGleaves 2004

The fourth lever is to examine the costs to serve customers – both servicing costs and the costs of ongoing relationships.

The final lever is one that is not available unless CPA has been carried out and that is the targeting of profitable-type customers in the first place.

Using these levers, it is possible to migrate customers to more effective cost-to-serve channels appropriate to each customer's actual profitability. In addition, some customers might have to be sacked. However, sacking is usually the last resort and it should be recognised that there are many good reasons why a company should have unprofitable customers (See Chapter 2 – Strategically Significant Customers). Sacking should be carried out in a diplomatic and structured fashion, and usually begins by raising prices for those customers or reducing benefits, e.g. free shipping. Customers should be targeted with changes made around the specific levers identified, and only if they are unwilling to accommodate the changes should they be sacked. Some of those sacked might be passed to smaller distributors that are also customers of the company. Others might come back as customers under the new terms after being sacked.

Customer segmentation recognises the key factors in relation to cost to serve and CPA develops a structured approach to customer

segmentation, and hence service offering, driven by customer profitability banding and strategic importance. The concept of MASP (most appropriate service provider) can be used to ensure that segmentation leads to enhanced customer profitability. Examples of how this works may be found in the case studies at the end of this book.

The customer response

In the case of companies where extensive customer migration and change have taken place as a result of the findings from CPA, customers were generally happy with the results, since the project had successfully aimed to enhance their experience and satisfaction.

Comments from customers included words to the effect that:

We wondered how long it would take you to notice that our credit terms were so generous.

I'm glad you don't send out a rep anymore. I don't have the time to see him.

Where customers were sacked, the process was handled in a consistent and planned fashion, and the majority of customers were either willing to change the way they did business, or to be moved to other channels. Some who left eventually came back under the new terms.

What could have been a painful process was handled in such a way as to keep the majority of customers satisfied.

Management barriers to making changes as a result of CPA

There are many barriers to making changes as a result of CPA and some of these can come from internal inertia and resistance.

- Sales force resistance – selling is considered to be a 'black art'.
- The sales force often has a different mindset – real value versus volume – and one ends up fighting against typical macho goals for the sales force.

- If we don't understand the method, we won't use the results. Lack of trust in results – cynicism – history doesn't repeat itself, for LTV calculations especially.
- Perverse incentives – based on rewarding behaviour that doesn't lead to additional profit.
- It is fine having a post-CPA strategy but operations can't use the information due to the current IT configuration.
- Clashing targets and strategy disjoint.
- 'The customer is always right' – need to challenge this assumption and ask if the customer is always profitable.

Conclusion

Customer profitability is a relatively poorly understood issue, which can have massive implications for the profitable growth of any organisation.

CPA can be a complicated process but it is grounded in a series of steps that are essentially intuitive. Most organisations currently do not have in place systems that are suitable for the measurement or management of individual customer profitability. This includes information systems, reporting systems, customer management systems and rewards systems.

Remember the five levels of cost, when considering customer profitability:

- cost of goods;
- cost of selling;
- cost to serve;
- relationship costs;
- business-sustaining costs.

Some advanced customer profitability concepts

The method of conducting CPA outlined in this chapter is robust and will provide usable data on individual levels of customer profitability.

There is more, however, to the story when we consider not just profit but also the timing of the cash flows, and the whole concept of economic profit and shareholder value.

Cash flow

The method outlined in this chapter is limited to a consideration of customer profitability, a key goal for organisations. However, 'cash is king', and for many organisations, especially smaller ones, the actual cash flow for each customer relationship could also be taken into consideration.

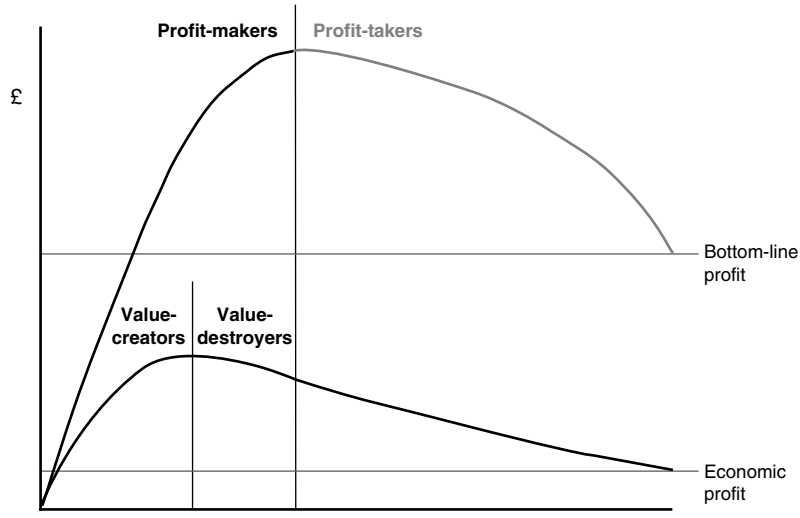
Some companies consider the impact on working capital or net working capital, which is defined simply as stocks + debtors − creditors, as part of a customer profitability process. There is a cost in extending credit to customers, and some allowance can be made for this.

Customer capital/equity

Accounting profit, discussed already in this chapter, is a very basic way to consider profit. The term economic profit is used to describe any profits over and above the opportunity cost of capital. A similar concept is economic value added (EVA™).

The same concepts will be true for customer value added (CVA). Customers, whether nominally *profitable* or not, will provide a spread of returns above and below the line of effective EVA return. This is shown in Figure 1.7.

Similarly, and while not the focus of this book, there is something to be said about customer capital in the context of intellectual capital and human capital. The excess value of a firm over its net assets is often ascribed to intellectual capital, and increasingly to human capital. However, the value of the firm is perhaps most accurately described as the sum of future profits from customers, discounted to a present value. In cases where a major customer defects from a business, the share price will drop to reflect this loss, despite the firm retaining the same intellectual and human capital. The really important message



NB This figure assumes that the company is making a bottom-line profit and that it is also making an economic profit. Economic profit is always less than bottom-line profit and even customers contributing to bottom-line profit will not necessarily return an economic profit.

Figure 1.7 Profit-makers and profit-takers

from this book is that the future value of a firm could actually be dependent on the profit generated by a small percentage of the customer base. So, in reality, there will be two whale curves for every business; one based on profitability alone and another, with even fewer profitable customers, if economic profit is taken into consideration.

The customer as a real option

When a customer completes a transaction, the supplier has an opportunity to make a profit on the transaction. Whether that opportunity is seized or squandered is dependent on the systems that are in place for managing customers. For example, if pricing is lower than the true cost to serve, the customer relationship will not be profitable to the company.

In fact, a series of options are built into all customer relationships. First, there is the option to make profit from the transaction or series of transactions comprising the relationship. The longevity of this option depends on the company's ability to retain the customer. If the customer is retained, another option arises, that of selling more to that customer through cross- and up-selling. Finally, there is also the option to develop the relationship into one that is even more profitable for you, but which can also provide superior value to your customers, through careful management of the modes and channels of interaction with the customer. Very few companies recognise these options clearly, and even fewer exploit them effectively. It might be possible to measure the value of customers using the options-pricing theory.