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Customer Profitability

Prospective vs. Retrospective Approaches in a Business-to-Business Setting

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The research question pertains to the development of a comprehensive model of customer profitability. In developing such a model, we rely upon the links between quality, customer satisfaction, loyalty, and profitability established in the literature in marketing and accounting, and place them into the business-to-business context. We maintain that customer profitability is expandable in three directions, two temporal and one spatial. The two temporal directions, represented by retrospective and prospective approaches, are discussed and analytically specified. The third direction is conceptualized as an ever-growing customer pool of "delighted" customers that become an advertising medium for the firm and its products (services). Implications of the three-dimensional model of customer profitability for the management control system are offered.

INTRODUCTION

Modern marketing managers are determined to use accounting information in order to create customer value. They attempt to direct the strategic focus by conducting customer revenue and customer cost analyses and, thereby, building customer profitability profiles [1]. Foster [2] states that:

> The 'why?' of customer profitability analysis can be reduced to the simple statement that each dollar of revenues does not contribute equally to net income. Differences in customer profitability can arise from either differences in revenue or differences in cost [2, p. 5].

Customer-profitability profiles help to pinpoint the contribution of each customer (or set of customers) to the

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Customer-profitability profiles help.

total profitability. The interests of the leading customers can then be emphasized in developing new products as well as in delivering existing products. These profiles also facilitate identifying "the least profitables," customers for whom the cost of serving them exceeds the associated gross margin.[1] Limited academic research related to the measurement of customer profitability and management control issues exists today.

Customer profitability has been explored by academics in the areas of marketing and accounting from different perspectives. Marketing literature suggests that " . . . marketing is concerned with the task of developing and managing market-based assets . . . that arise from the comingling of the firm with entities in the external environment" which include customer relationships [3, p. 1]. Cost accounting literature has concentrated on measuring customer revenues and customer costs and building their taxonomies within Activity-Based Costing [1, 2]. Among the properties of customer-profitability analysis, emphasis is placed on such features as allowing the measurements to cut across the entire value chain, encompassing multiple transactions in multiple periods and selectivity in the scope of customer-specific analysis (aggregate vs. narrow). Others suggest that emphasis on dimensions of "product," "price" and "responsiveness" be correlated with future sales [4, p. 37].

The literature in marketing and cost accounting suggests the need for responses to at least four major challenges. To ascertain usefulness of customer profitability analysis the following problems must be solved: (1) development of reliable customer revenue and customer cost figures; (2) recognition of future downstream costs of customers (environmental, litigation, warranty, etc); (3) incorporation of multiple periods into the analysis, and; (4) recognition of different drivers of customer costs [1]. In responding to these challenges, proposals consider several factors that highlight potential benefits from allocating resources across customers. These factors include: (1) levels of the short-run and long-run customer profitability; (2) likelihood of customer retention; (3) potential for customer growth and customer's industry growth; (4) increases in the overall demand from having well-known customers, and; (5) use of customers as a source of ideas about new products and/or ways to improve existing products.

The purpose of this research is to extend the literature in accounting and marketing by developing a more comprehensive model of customer profitability. In accomplishing this task, the literature that links quality, satisfaction, loyalty, and profitability is relied upon and extended into a business-to-business marketing context.[2] Customer profitability is conceptualized as expanding in at least three directions: two temporal and one spatial. After building the model, managerial and control implications of this more complete model are discussed. This approach is limited to theoretical specification of the measurement model as empirical testing of the model is underway.

The conceptual development of customer profitability is organized as follows. The next section presents retrospective and prospective theories of customer profitability and their analytical specifications. Additionally, contemporary research in marketing that investigates the nature and strength of the link between customer expectations, quality of the product, and customer satisfaction is reviewed. Section three develops the idea of future sales influenced by a customer in the form of an ever expanding profitability stream and makes a point that "de-

[1] Customer-level operating costs may include customer acquisition, order fulfillment and post-sale services. The profit metric chosen for use at the customer level is assumed to be congruent with overall company strategy.

[2] For a somewhat different focus, [4–7].

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