CGMA TOOLS

How to manage customer value

CGMA
Chartered Global Management Accountant

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Contents - Part 1

Two of the world's most prestigious accounting bodies, AICPA and CIMA, have formed a joint venture to establish the Chartered Global Management Accountant (CGMA) designation to elevate the profession of management accounting. The designation recognises the most talented and committed management accountants with the discipline and skill to drive strong business performance.

Introduction and overview 2

Manage customer segmentation 3

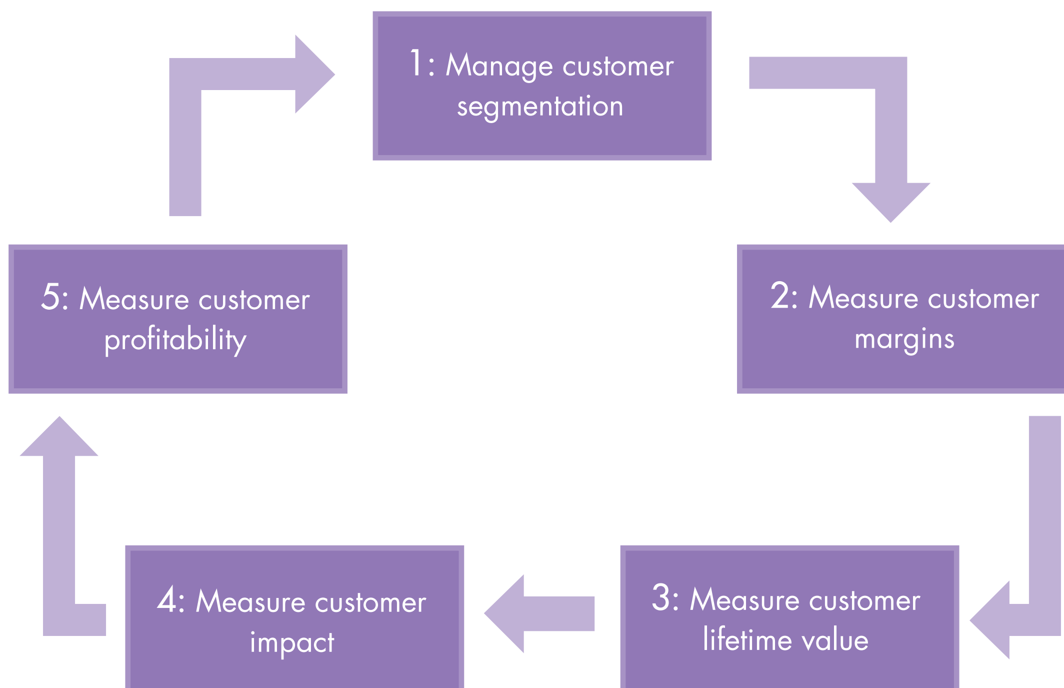
Measure customer margins 4

Introduction and overview

The focus on customer relationship management has become central to all organisations. Companies have increasingly recognised the significant costs related to the loss of customers and are trying to better understand, measure, manage and improve customer retention. Further, these organisations are examining how to measure and improve long-term customer lifetime value.

This tool provides a systematic approach for addressing customer value issues that include: customer segmentation, measuring profitability, estimating customer lifetime value, identifying additional sources of customer value and managing to enhance customer profitability. This tool also demonstrates how organisations can create more value for and derive increased value from customers.

Figure 1: The customer value management cycle



Manage customer segmentation

Customer segmentation refers to the process of dividing customers into groups for decision-making purposes. Segmentation allows the company to provide differential advertising or value propositions to different customer groups. The appropriate level of segmentation varies according to (a) the purposes for which segmentation structures will be used and (b) cost and profitability variations between customers within segments.

Segments are often determined on the basis of customer similarities, such as personal characteristics, preferences or behaviours:

- **Demographic segmentation** segments customers based on their observable characteristics, for example, customer demographics like age, geographic area or income level. However, for many products and services, demographic characteristics are not fully representative of buying behaviour and have not been useful in predicting customer behaviour.
- **Psychographic segmentation** builds upon demographic segmentation by including criteria that further categorise a particular group of customers. Segmentation based on psychographic and lifestyle characteristics includes criteria such as attitudes and interests, values and social roles. The psychographics approach assumes that a customer's choices and behaviour are related to the customer's habits and routines.
- **Behavioural segmentation** based on buying behaviour represents the most effective of the current segmentation approaches used today. Customer relationship management software available today enables companies to harness this valuable data.
- **Analytic segmentation** integrates criteria such as cost into the value calculation of a company's customer segments. Analytic segmentation provides the firm with an evn more accurate picture of customer profitability and buying behaviour. This, along with psychographic and demographic characteristics, allows companies to more effectively target their most profitable customers.

Box 1: Analytic segmentation examples

BOC, a UK-based supplier of industrial and medical gases, now part of Linde Group, utilises an analytic approach to segmentation. The company's strategy includes identifying the distinct requirements of its customers, such as value placed on service and/or the desire to obtain the lowest price. After identifying its customers' requirements, BOC is able to adapt its business model to maximise the operating performance from serving the requirements, reducing cost and increasing customer value from the customer's perspective.

This is also true for the planning strategies of the American industrial gas market. Air Products & Chemicals seeks out customers who need high levels of technical assistance for their applications (eg, liquid nitrogen freezing of hamburgers or oxygen enhancement of blast furnaces) for which they can charge a high premium price. They spend few resources competing in the area of low-margin commodities such as argon and oxygen used for welding.

Manage customer margins

Although almost all companies have carefully designed processes for assessing the profitability of their products, most are far behind in assessing the profitability of their customers. Assigning non-product costs allows measurement of customer profitability through systematically measuring customer-related costs and assigning them to the responsible customers.

Many companies have used activity-based costing, or ABC, to assign non-product costs. Activity-based customer costing recognises that costs required to serve customers extend beyond direct costs, and provides a method for identifying and assigning indirect costs to the specific segments or customers responsible for them. Activity-based product costing can also be used to better estimate product costs as well.

Today much available software allows automatic assignment of product costs, and in most companies, information about the relative margins of customers and segments is widely available. As might be expected, the costs driven by a customer or segment extend far beyond the costs of the products they purchase. Service and support requirements can vary significantly among customer groups. See box 2 for examples of cost categories.

Box 2: Assigning non-product costs

One way to identify cost categories and the costs they might include follows:

- **Order-level costs** are costs associated with order placement and processing These costs include order entry, picking inventory, delivery and billing costs.
- **Customer-level costs** are costs associated with individual customers or segments. They include costs such as acquisition costs, advertising and promotions, selling, sales returns, responding to enquiries, relationship management and managing receivables.
- **Channel-level costs** are associated with distribution channels. They include fixed locations, delivery equipment, information technology and marketing costs.
- **Market-level costs** benefit all channels These costs include general research and development, branding and other general marketing, market research and other marketing functions.
- **Enterprise-level costs** are high-level organisation costs. They include administrative costs such as administrative salaries, facilities and financing costs.

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