



Merging Behavior-Based Profitability
with
Traditional Organizational Reporting Methodologies
-- an idea that's taking flight.

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The dream of flying is as old as mankind itself. Yet the concept of the airplane has only been around since the 19th century. Before that time, men and women tried to fly by imitating birds. It was only by utilizing a simple shift in technology – from movable wings to fixed wings – that allowed the Wright Brothers to achieve controlled flight and change the world forever. This shift made flight a reality.

A similar shift is taking place in business database technology today that is allowing companies to maximize the profitability of their customer databases. It's a concept that's also taking flight.

Making customer databases more profitable

For years, companies have successfully maximized customer profitability through the use of general ledger reporting systems. However, thanks to modern technology, many organizations today are seeking to extract even more value from their existing financial systems. To accomplish this, they are looking for reporting structures that can help them understand and maximize the profitability of their existing customer base. This is particularly true in our current economic environment where companies can no longer sustain growth through the purchase of customer databases alone. Instead, companies are finding that to be truly competitive in the 21st Century, they must grow profits from existing customers.

If you're familiar with the 80/20 rule, then you understand the concept that roughly 20 percent of a company's customer base accounts for 80 percent of its revenues. What this formula also implies is the remaining eighty percent of a company's customer base is either profit neutral or possibly even eroding value for the organization. So by merely adding more customers to its base through direct acquisition, a company might actually be reducing its value while it's increasing revenue. A potential formula for disaster.

This need for organizations to sustain and grow profits from internal opportunities has led companies to search for retention and cross sell solutions that differentiate service levels based on the total value exchange of a customer. In other words, the customers that drive the most value for your company should be the customers that receive the highest levels of value from your organization in the form of service and product offerings. This means focusing more time on retaining your best customers, while spending less time on marginally profitable customers, and ridding yourself of unprofitable ones. *Sound easy? Well, like flying, it needed a shift in technology.*

To understand the dynamics of customer profitability, it's important to understand the drivers of profit or loss as these interactions flow through a customer's record and to evaluate the specific risk and spread funding characteristics of individual products and services held by the customer. If a company only looks at organizational-based reporting measures that average customer revenue, funding, cost, and risk information regarding products and services, it is missing specific information critical to understanding the true behavior based profit of the customer.

While organizationally-based information represents a level of "truth" within the organization, it needs access to deeper levels of customer data to determine true profitability. Behavior-based analysis offers this deeper level of access to customer actions, but does not reach its full potential if not tied to the big picture. Let's look at the value of each methodology.

Traditional organizational reporting – *it's all about the general ledger*

From the beginning of modern business, organizational information has been based on profit and service center activity, and the financial activity of business units that drive the detail of general ledger reporting. For instance, the purchase of pencils, paper, and payment of salaries, as well as the ownership of products and services, has defined the level of available data for business analysis. Once this information has been collected, a business can use it for budgeting, planning, and forecasting – all primary financial control tools.

This information comes from a company's business units and is then tied directly to the general ledger. It is both highly accurate about the activity of the business unit and highly aggregated with respect to the underlying details of the customer behavior that drives balances, revenues, and costs for customer activity.

The general ledger is mandated by regulators and the accounting industry, and has become the basis for management reporting, regulatory reporting, control and comparison of operating results since the 1900s. Without this valuable information, an organization could not operate effectively. However, as companies realize that customer databases can now be turned into goldmines of potential profit, the general ledger system alone has not been able to effectively access this customer information and turn it into bullion. This is where behavior-based measuring comes in.

Behavior-based profitability – *it's all about the data*

To get a deeper view of customer profitability that reflects the behaviors of individual customers requires a great deal of data about a customer's activities. This level of transactional information based on a customer's interactions with an organization is stored in the company's database and is driven by specific behavioral models.

These specific behavioral models include base level profit objects, such as accounts, passenger records, subscription numbers, and shipment figures, transaction and interaction information, and other customer details that are required to give a company a full view of the customer's value to the organization. In addition, there are costs and revenues that are not transactional-based – such as the fees and costs of establishing, maintaining, and closing a relationship – that must be captured and allocated to get true profitability.

To find the true value of behavior-based profitability, it's important to look at four areas within this methodology that can help companies calculate their most valuable customers, but also identify and track those that are least profitable.

1) Risk-adjusted funding costs and values

Customer balances are generally correct to the general ledger, and include both monthly and/or cycle-end balances. However, to achieve detailed level profitability often requires the use of daily average balances for calculation of spread revenue and risk, making this level of information not readily available in general ledger.

Some organizations have a developed mature funds transfer pricing process for balance valuation that helps them identify the cost and/or value of customer holdings with a high degree of accuracy. Likewise, the actual interest amount paid or received by customers can be tracked in detail at the account level by the application accounting systems.

The allocation of capital to the profit object balance or the profit object itself is largely a matter of attaching the models that already exist within most organizations to the customer account. While there may be no direct correlation of some types of risk to the customer level, many organizations are using workable proxies around such things as total expense or total revenue at the profit object level. These processes help to identify risk-adjusted funding costs and values, and attach them to customer accounts to attain true value.

2) Fee revenue

Specific fee revenue figures at the account/customer level are usually quite easy to correlate to the general ledger. However, some level of modeling or approximation may be needed to make allowances for small buckets of revenue as the application accounting system or back room operations may hide the necessary detail needed to account for this revenue. In general, between 95 percent and 99 percent of the detail is available, but 100 percent of detail must be accounted for and allocated to achieve true customer account accuracy.

3) Costs

Customer activity level costs are often difficult and time-consuming to capture and they are generally not as up-to-date as the figures available for a company's products and services. This is often the case because the time and effort involved in capturing customer level activity costs often lag the organization's creation of new products and channels as they enter the market. Any remaining costs that are not typically identified in general ledger, such as overhead costs that do not directly tie to customers or their level of individual activity, should be apportioned to customers and activities to which they apply. In order to attain accurate data at this level, it's important that well-thought-out and specific apportionment schemes are in place so the right groups of profit objects get the right amount of cost.

In addition, some of the costs of doing business just do not happen at the customer level. For instance, capital for business, market, and operational risks are only indirectly related to customer activity. And fixed assets expense and organizational infrastructure costs arise from organizational mandates and are also very loosely tied to customer activity. But by capturing these activities that are most common and represent the highest amount of cost, the organization can identify and allocate essential costs that both drive and affect customer profitability. Once these figures are captured, additional costing work could then be driven by customer activity levels and product offerings so that the most important costs are always part of the profitability calculation.

4) Risk

Just as the attributes of behavior determine revenue and expense, it is the attributes of the profit object that determine the level of credit risk that should be assigned to customers. Many organizations use credit scores to accomplish this task. Profit objects without a credit score can, at a minimum, use a portion of the monthly reserve for losses to approximate the cost of credit risk. There exist many complex and highly accurate ways of determining the risk of loss given default on a specific profit object. Additionally, there are many highly sophisticated and accurate ways of deterring the potential for loss on a specific profit object. All of these methodologies can be reconciled in detail back to the financial results from the general ledger, therefore improving analysis and projections going forward.

While all of these areas improve the level of accuracy of behavioral-based reporting, they reach their full potential when tied to a company's general ledger to achieve true customer profitability.

Merging behavior-based and organizational-based reporting – it's *about customer profitability taking flight*

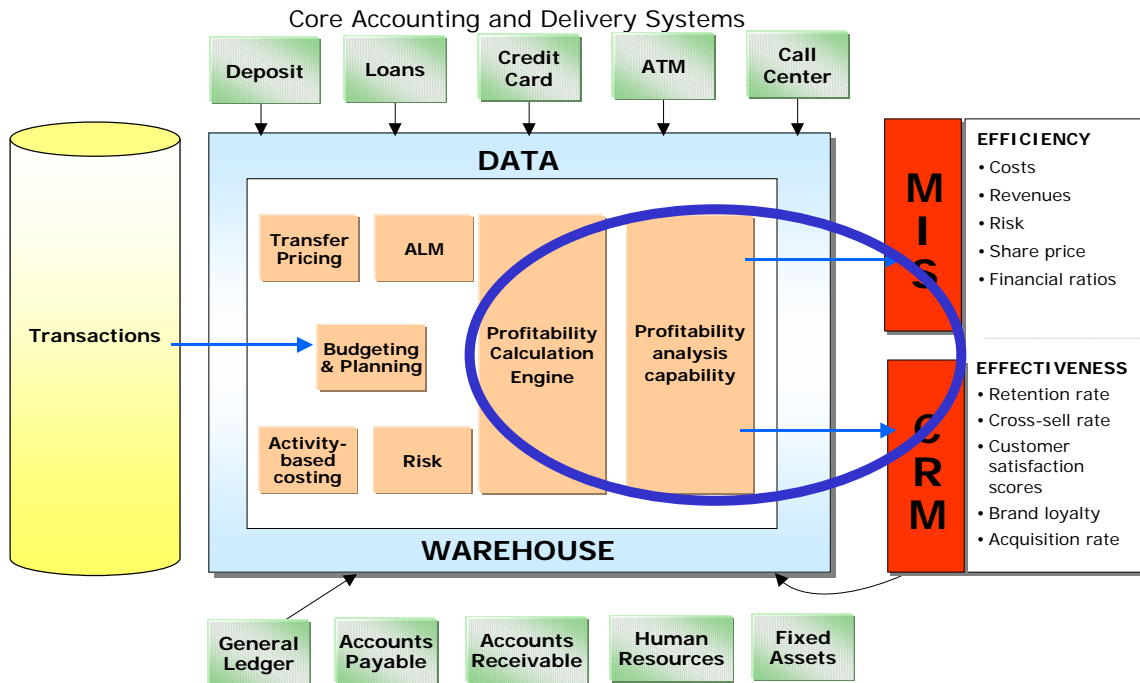
Maintaining both behavioral-based and organization-based reporting methods can be expensive to an organization. Yet, both systems serve essential roles in the organization and neither can be dispensed with. To merge these two methods of analysis, it's necessary to create an environment that captures the detailed data *and* serves the need of management to plan for people and pencils. Further, this solution must accomplish its tasks in a time-saving manner and be able to be quickly corrected when new and unforeseen issues arise.

For successful development of financial management capability, whether this is G/L, Risk Management, ALM, Budget & Planning, Cost Allocation, Fund Transfer Pricing, Customer Value Management, Performance Management or Statutory reporting – a comprehensive architecture that addresses all financial management needs is essential. Having such an architecture enables an organization to detect the "white spots" and to prioritize future customer development activities.

Core accounting and delivery system architecture

The central piece of a successful financial management architecture is the enterprise data warehouse which brings together all of the essential elements that support an organization's financial needs, including G/L, Risk Management, ALM, and so forth. As more detail is supplied

by the application systems and brought into the structured warehouse environment, the information becomes more consistent and reconcilable. This allows a business to have a complete view of its customers and its organization – while supporting the specific financial reporting needs of the company.



By deploying this new type of enterprise database architecture, it's now possible to marry the accounting system information that drives the books as well as the account level behavior based profitability information that identifies customer profitability. As all components of both reside in this single architecture, the comparison and contrasting of the reporting results are made into one efficient task. And while the results of the profitability metric may not always balance directly to the financial statements, they are certainly reconcilable within this environment. This reconciliation process can provide companies with a roadmap to improve the accuracy of such things as the costing system, operations for the collection of revenue, the tying of a credit score to the provision for loan losses, and the verification of the ALM process to actual customers as opposed to just a portfolio level.

Putting it all together – *making customer profits soar*

It's becoming increasingly clear that typical general ledger environments alone are not enough to support a company's need to generate highly accurate and profitable customer behavioral models. Equally, it's clear that pure behavioral-based information is not enough to maximize corporate profitability if it is not tied to the general ledger. However, when these methodologies are merged in a company's enterprise database architecture, organizations are able to increase service to their most profitable customers and reduce or replace their unprofitable ones. Together, they are helping organizational profits to soar.

Yes, it took mankind thousands of years to realize that a simple shift in technology would allow humans to fly. A similar shift in technology is making it possible for companies to access a deeper level of customer information, helping businesses to increase customer profitability in ways that were undreamed of just a few years ago. *Data warehouse technology – allowing true customer profitability to fly.*