

# Marketing Accounting Metrics



Peter R. Dickson, Phd.  
Florida International University

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This tutorial teaches marketing accounting metrics and decision frameworks to the many millions of managers interested in improving decision making in marketing and sales. Education research has revealed that on-average, non-accounting students, particularly marketing students, possess weak analytic skills and are poorly trained in marketing management accounting. This state of affairs has existed for decades despite clear evidence from recruiters that they wish to have this education deficiency addressed.

The tutorial has been designed to be used in undergraduate and graduate marketing principles courses either as a stand-alone tutorial in a course or incorporated into the course lectures.

It is the most comprehensive tutorial on marketing accounting available. Its rigor is designed to be at the level of the certification standards of the IMA, the *Institute of Management Accountants*. The tutorial has its foundations in fundamental management accounting and the Balanced Score Card. Fifteen of the 25 decision spreadsheets are based on scholarly research published in the major marketing and management accounting journals.

Since 2008, over 10,000 undergraduate and graduate students have taken the tutorial and exam. The pass rate of undergraduate students who have taken the course in their first marketing principles course is around 60%. The pass-rate of graduate students is over 80%.<sup>1</sup>

The tutorial's content has also been designed so that students who pass the tutorial's online exam and earn the *Marketing Accounting Competency* certificate are well prepared to enroll in and study for the IMA Professional Certification Course, the highest professional qualification in management accounting available nationally and internationally.

I wish to thank my publisher, colleagues and students who over the years have given me advice on how to improve the tutorial.

Peter R. Dickson PhD.

Miami, Florida

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<sup>1</sup> Chen, Y.J., Greenberg, B., Dickson, P.R. and Goodrich, J., "Learning Marketing Accounting Skills in the Introductory Marketing Course: The Development, Use, and Acceptance of a Self-Study Tutorial," *Marketing Education Review*, 22(3), 2012, 241-249.



## Marketing Accounting Metrics

# Chapter 1. Thinking about metrics

“When you can measure what you are speaking about, and express it in numbers, you know something about it.” Lord Kelvin circa 1891

Marketers who do not understand the cost and net profit implications of what they are talking about would be judged by Lord Kelvin to not know what they are talking about.

A metric is a measure that quantifies a trend, dynamic or characteristic. Today, fluency in metrics, their calculation and use in decision making are crucial management skills. Marketers need to learn about a set of metrics that provide different decision perspectives. Metrics help a firm maintain a productive focus on customers and markets. They can help managers identify the strengths and weaknesses in both strategies and implementation plans. Mathematically defined and widely disseminated and used, metrics can also become part of a precise, operational language within a firm and across the sales and marketing professions.<sup>1</sup>

Marketing accounting metrics are measures of marketing performance such as: customer satisfaction, customer acquisition, customer loyalty and retention, customer profitability, sales, costs, cash-flow, return on investment (ROI), return on assets employed (ROA) and added shareholder value (capital) creation. They are measures that all managers, and all business majors should know about and be able to think about.

Over several decades, the marketing function has diminished in its role and status in many large American companies and some think that it has to do with marketing’s lack of performance accountability.<sup>2</sup> This lack of performance accountability has been, in turn, partly because of the accounting illiteracy of marketing executives. For example, when marketers listen to discussions on costs and profitability, management accounting and financial analysis and do not fully understand what is being talked about, it diminishes the role and status of marketing and marketers. This tutorial is designed to rectify this long-standing deficiency. It provides a foundational understanding of marketing accounting that can be built on by further study of marketing metrics<sup>3</sup>, case analysis teaching and project work. The tutorial also demonstrates how important marketing accounting is to the whole firm and why every business graduate should have a solid understanding of marketing accounting.

Mastering this tutorial will teach you to think as a manager should. Excelling in this tutorial will give you an advantage over managers who have not taken it. The likelihood that you can master this material is very high. What is the basis of this claim? It is based on feedback from hundreds of the thousands of students who have taken the tutorial and suggested ways to improve it.<sup>4</sup> Adopting all the suggested improvements has made the tutorial very user friendly. The tutorial also assumes that students have not taken an accounting or finance course before, or if they did, not very much was learned and retained. We also understand that many students stress out when asked to do mathematical analysis.

<sup>1</sup> Farris, P.W., Bendle, N.T., Pfeifer, P.E and Reibstein, D.J., *Marketing Metrics*, 2<sup>nd</sup> Ed. 2010; NJ., Prentice Hall. This reference book is highly recommended and available at Amazon.com for a very modest price.

<sup>2</sup> See Webster, F. E., Malter, A. and Ganesan, S., “Can Marketing Regain a Seat at the Table?” *MSI Report* (No. 03-113), 2003; Nath, P., and Mahajan, V., “Chief marketing Officers: A Study of Their Presence in Firm’s Top Management Teams,” *Journal of Marketing*, 72 (1), 2008, 65-81.

<sup>3</sup> Farris et al. 2010, *ibid*.

<sup>4</sup> Chen, Yi Ju, Barnett Greenberg, Peter Dickson, Jonathan Goodrich (2012), “Learning Marketing Accounting Skills in the Introductory Marketing Course: The Development, Use, and Acceptance of a Self-Study Tutorial,” *Marketing Education Review*, 22(3), 241-249.



So to make it easy for you, we emphasize plug-and-play, learning-by-doing problem solving. But do not be fooled. This is not “Analysis for Dummies.” Why not? Because what we just described is learning to use a suite of spreadsheets that add a lot more procedural rationality (quality) to your decision making and problem solving.<sup>5</sup> And in the process of answering the questions, following the logic to solve the problems, you will not only develop spreadsheet agility and ability. You will also significantly improve your intuitive ability to do management accounting and capital budgeting in your head by using the spreadsheets’ decision framing that your working memory has adopted. Furthermore, you will think and make more rational decisions because the decision process imposed by each spreadsheet has high procedural rationality and you will use less intuition, emotion and fast (seat of the pants) thinking in your decision making.<sup>6</sup> You will become more competent and confident in your analytic thinking through directed, step-by-step learning by doing problem solving. That is the mission and promise of the tutorial.

## Most useful marketing metrics

A recent survey of 194 senior marketing managers and executives working in a diverse sample of industries were asked to rate the usefulness of particular metrics in monitoring and managing their businesses.<sup>7</sup> Net profit (total sales (\$s) - total costs (\$s)) was rated by 91% of the marketing managers as a very useful metric. It is the outstanding most important metric amongst managers 13% points ahead of the next metric, margin % ((total sales (\$s) –total costs (\$s))\*100/total sales (\$s)) and 14% ahead of the third ROI (return on investment: Net profit (\$s)\*100/Investment (\$s)). The fourth ranked metric, customer satisfaction, was rated a very useful metric by 71% of the sample. That is 20% points behind net profit at 91%. The following are the percentages of managers rating the metric very useful:

Net profit	91%
Margin %	78%
ROI (return on investment %)	77%
Customer satisfaction	71%
Target \$ sales (revenue)	71%
Actual \$ sales revenue	70%
Target sales volume	70%
ROS (return on sales %)	69%
Customer loyalty	69%
Annual growth %	69%

In the next section we will develop a framework for thinking about these and other marketing metrics first from the customer demand side and then from the firm supply side.

## Framing your thinking

The long established way of thinking about a competitive market in economics is a demand curve that intersects with a supply curve at an

equilibrium price and quantity sold. This is Economics 101 and is an excellent way of illustrating and understanding how price equilibrates supply and demand. It is a good start but it is just a little too simple – the modern market manager seeks to measure customer demand metrics that determine the demand curve such as customer income, confidence, awareness, preferences, satisfaction, loyalty, intentions and finally customer purchases. There are also important metrics that determine the supply curve such as: number of suppliers, capacity, fixed and variable costs, productivity and profitability.

A different way of thinking about markets is dynamically; where changing supply is constantly changing demand that is constantly changing supply as in Figure 1 below. Please study it now. Figure 1 makes it clear that in its routine due diligence, marketing should account for changes in demand by tracking key demand metrics and account for changes in supply by tracking key supply metrics and understand their causes and effects. The changing set of firm performance metrics are observed to change consumer metrics that in turn lead to further changes in firm performance

<sup>5</sup> Simon, Herbert A., “From Substantive to Procedural Rationality,” in Spiro J. Latsis (ed.) *Method and Appraisal in Economics*, U.K., Cambridge University Press, 1976, 129-148; “Rationality as Process and as Product of Thought,” *American Economic Association Richard T. Ely lecture*, May, 1978, 1-16.

<sup>6</sup> Daniel Kahneman, *Thinking Fast and Slow*, New York, NY., Farrar, Straus and Giroux, 2011

<sup>7</sup> Farris et al. (2010) *ibid*.



metrics. Admittedly, there is likely to be a lot of performance metrics to keep tabs on but management accountants have come up with a clever organization that frames such an analysis. A “Balanced Scorecard” that measures performance on a set of demand and supply metrics that can then be presented on a management “dashboard”, where all of the various metrics are continuously reported in window graphs on your desk-top computer screen. The monitoring and managing of these performance metrics is a large part of the future of management accounting, marketing, supply-chain management and business strategy.<sup>8</sup>

Notice the structural similarity between the top supply-changes-demand-that-changes-supply (Figure 1.1) and the bottom Balanced Scorecard (Figure 1.2.) They both emphasize the measurement of changing demand and supply metrics. The Balanced Scorecard approach connects customer, demand-side metrics to owner supply-side metrics. In the Balanced Scorecard, the key demand metrics are customer outcome measures and the key supply metrics are owner outcome measures. Key internal processes such as product development, manufacturing, distribution and customer relationship processes drive the demand and supply metrics. The Balanced Scorecard gives great emphasis to process learning, process change, process improvement and process thinking. It puts into practice the market disequilibrium theory illustrated in the Figure 1.1.

The Balanced Scorecard proposes a set of system controls that can be used to manage the core added-value processes of the firm directed at satisfying the customer and earning profits. It has been the framework of choice used by many management accountants and business strategy consultants for over two decades. For further examples of the Balanced Scorecard see the referenced HBS articles in the footnotes below.

The common problems with the Balanced Scorecard control system are:

1. Senior management is sometimes not committed or involved in the project. The project has to be owned by everyone and become part of the culture, truly institutionalized. Otherwise, when its champions leave, the Balanced Scorecard may become another failed management fad. The common frame of thinking also increases communication and understanding between managers which is why all managers should use it, from Board to Shop Floor.
2. Sometimes too much of an emphasis is put on having perfect measures and having a lot of them, rather than an emphasis on using what is available, making do until better tracking measures are developed, and focusing on doing something to improve performance. For example, the trick to customer satisfaction metric management is not in the measurement but in connecting serious management incentives, such as job promotion, directly to customer satisfaction ratings. Then attention will be paid and effort will be made to improve customer satisfaction.

An outstanding implementation of the Balanced Scorecard system, called Total Performance Indicators, was achieved at Sears in 1995.<sup>9</sup> Within a year customer satisfaction increased by close to four percentage points. According to the marketing accounting analysis of the relationship between customer satisfaction and customer profitability TPI added close to \$250 million to shareholder value. It is an extraordinarily informative and insightful example of demand side customer focus and supply side process focus. It is also very instructive that Sears, facing new competition from all directions, could not keep growing customer satisfaction, and the percentage of customers satisfied with Sears has declined in recent years.

<sup>8</sup> See Robert S. Kaplan and David P. Norton, “The Balanced Scorecard – Measures that Drive Performance,” *Harvard Business Review*, January-February, 1992, 71-79; “Putting the Balanced Scorecard to Work,” *Harvard Business Review*, September-October, 1993, 134-147; “Using the Balanced Scorecard as a Strategic Management System,” *Harvard Business Review*, January-February, 1996, 75-85.

<sup>9</sup> Rucci, Anthony J., Steven P. Kirn and Richard T. Quinn, “The employee-customer profit chain at Sears (analysis of business culture change at Sears, Roebuck and Company),” *Harvard Business Review*, 76, January-February, 1998.



Figure 1.1

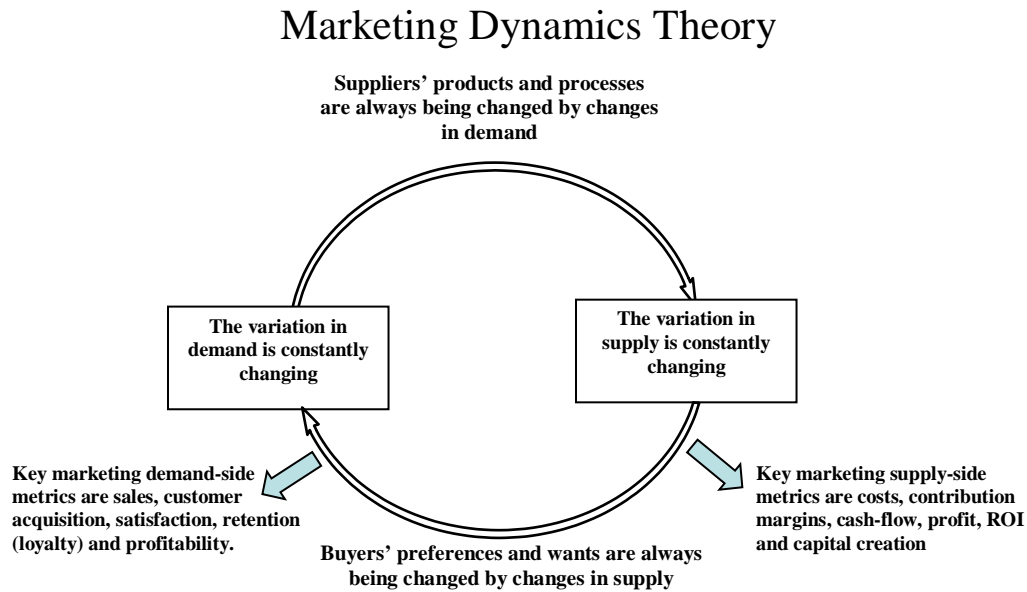
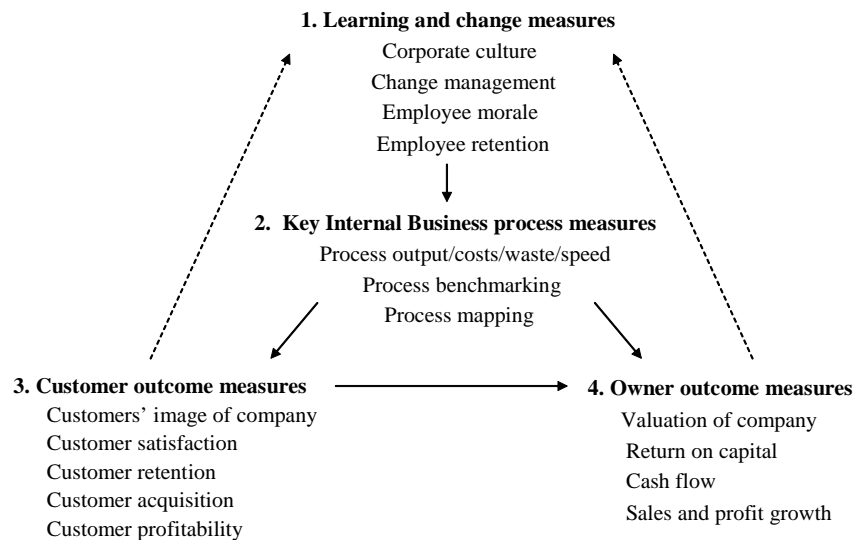


Figure 1.2

## The Balanced Scorecard Approach to Performance Evaluation



Rather than just focus on cost reduction and profits, management accounting best practice recommends control systems that measure all of the above drivers of customer satisfaction and shareholder value, and then set objectives, targets and planned initiatives for each measure. Very few companies employ such a comprehensive performance evaluation system but most are moving in the right direction. Source: Robert S. Kaplan and David P. Norton, *The Balanced Scorecard*, Harvard University Press, Boston, MA, 1996.



## Customer focused business process control

The great management thinker, teacher and consultant, W. Edwards Deming, advised accountants to view work as a process and to become process thinkers who control processes, rather than controlling people and cost centers. He also directed management accountants to develop process systems controls that are customer focused and that increase the learning capabilities of the firm.<sup>10</sup> He might have given the same advice to marketing executives. Note the key ingredients: new process system controls, customer focus, and improving the learning processes of the firm. “Companies need to map and improve customer-focused processes.”<sup>11</sup> These ingredients are all part of the Balanced Scorecard approach.

Professor Robert S. Kaplan, a leading management accounting thinker and writer over the last 30 years, has concluded: “Process drivers are the factors that affect the efficiency of performing the activity. Take an activity such as materials movement. The ABC [Activity Based Costing] model will calculate the total cost of performing this activity and then link it to products based on an activity driver such as number of material moves or the distance of the move.”<sup>12</sup> The activity based costing process is further explained in Chapter three of this tutorial.

According to leading marketing scholars, the processes that need to be thought about and that drive profit, ROI and shareholder value are a businesses’ product development management (PDM) processes, supply-chain management (SCM) processes and customer relationship management (CRM) processes.<sup>13</sup> Managers need to improve these processes in ways that increase cash-flow, speed up the cash-flow and increase the certainty and reliability of the cash-flow by employing many different tactics and processes (see the Table 1.1 below which makes some 50 Balanced Scorecard links between process tactics, cash-flow and shareholder value). The goal is to increase shareholder profits and value.

Another leading management accounting thinker, H. Thomas Johnson, has recommended that management accounting needs to understand and improve the processes that generate costs rather than simply “manage” activity costs: “Begin at the beginning – by articulating a customer focused mission statement and then encouraging everyone to help map and systematically improve the processes in which they work.”<sup>14</sup> The goal and the purpose of a marketing manager cannot be better defined. According to Johnson, “Survival requires astute management of root causes. In today’s global economy that means optimizing a system of stable processes that is capable of profitably exceeding customer expectations. To optimize their systems, companies must listen to the ‘voice of the customer’ and the ‘voice of the process’.”<sup>15</sup> Listen to the voice of the customer and the voice of the supply process and understand how they combine.

<sup>10</sup> Johnson, H. T., “Deming’s Message for Management Accountants,” *Management Accounting*, September, 1992, 34.

<sup>11</sup> Johnson, H. T., “It’s Time to Stop Overselling Activity-based Concepts,” *Management Accounting*, Sept., 1992, 32.

<sup>12</sup> Kaplan, R.S., “In Defense of Activity-Based Cost Management” *Management Accounting*, November, 1992, 60.

<sup>13</sup> Srivastava, Rajendra K., Tasadduq A. Shervani, & Liam Fahey, “Marketing, Business Processes, and Shareholder Value: An Organizationally Embedded View of Marketing Activities and The Discipline of Marketing,” *Journal of Marketing*, 63, (SI), 1999, 168-179.

<sup>14</sup> Johnson, op cit., 26-35.

<sup>15</sup> Johnson, H. Thomas quoted in Jayson, Susan, “Focus on People –Not Costs,” *Management Accounting*, September, 1992, 28.



**Table 1.1**  
**Processes and Their Cash Flow Drivers of Shareholder Value**

	<b>Product Development Management Process</b>	<b>Supply Chain Management Process</b>	<b>Customer Relationship Management Process</b>
<b>Accelerate cash flows</b>	<ul style="list-style-type: none"> <li>Speed up whole process</li> <li>Reduce time to market</li> <li>Reuse modular components</li> <li>Concurrent engineer with Partners</li> <li>Pre-sell to partner network</li> </ul>	<ul style="list-style-type: none"> <li>Reduce order-delivery cycle time</li> <li>Automatic replenishment</li> <li>Automate payment</li> </ul>	<ul style="list-style-type: none"> <li>Intensify and shorten campaigns</li> <li>Reduce customer solution development time</li> </ul>
<b>Enhance cash flows</b>	<ul style="list-style-type: none"> <li>Differentiate products/services with design excellence</li> <li>Cannibalize existing low margin offerings with higher margin offerings</li> <li>Simplify designs, reduce costs</li> <li>Consult customers about simplification</li> <li>Share modular components</li> <li>Reuse designs</li> <li>Use virtual component testing</li> <li>Acquire/licence technology</li> <li>Design for ease of assembly</li> </ul>	<ul style="list-style-type: none"> <li>Constantly seek new sources of global supply</li> <li>Re-engineer congestion points in supply-chain</li> <li>Use just-in-time supply</li> <li>Use see-down-the-channel information systems</li> <li>Use dynamic pricing/ yield management to manage perishable inventory</li> <li>Use in-transit customs clearance</li> <li>Use wireless UPC tracking technology</li> <li>Create parts pools with rivals and customers</li> </ul>	<ul style="list-style-type: none"> <li>Support most profitable customers with how-can-we-better-serve you innovation</li> <li>Raise prices on unprofitable customers</li> <li>Cross-sell complementary consumables, service</li> <li>Sell network partner products and services</li> <li>Create new customer solution packages</li> <li>Track loyalty/profitability relationship</li> <li>Discover new global markets/search for searching buyers</li> </ul>
<b>Reduce cash and variance</b>	<ul style="list-style-type: none"> <li>Ramp-up rate of innovation</li> <li>Create dominant tech. standards with suppliers and rivals</li> <li>Use patent protection, non-disclosure agreements</li> <li>Shift to an outsourced variable cost structure</li> <li>Reduce face-saving, pet design projects</li> <li>Reward development teams for long-term performance</li> <li>Over 50% of profits should come from under three year old products</li> <li>Reduce not-invented here risk markets</li> <li>Avoid product-service markets subject to cyclical demand</li> <li>Develop counter-cyclical product/service lines</li> </ul>	<ul style="list-style-type: none"> <li>Outsource uncertain demand delivery</li> <li>Don't start competing with distributors</li> <li>Design hard-to-copy delivery processes</li> <li>Negotiate long-term contracts with suppliers and distributors</li> <li>Do not single source</li> <li>Eliminate high-low price promotions</li> <li>Cover currency fluctuation risks</li> <li>Cover crucial input price fluctuation risk</li> <li>Reduce dishonest end of quarter sales reporting practices</li> </ul>	<ul style="list-style-type: none"> <li>Focus on profitable customer retention rather than high risk acquisition campaigns</li> <li>Repeat profitable campaigns until they cease to be profitable</li> <li>Bail-out early on bum campaigns</li> <li>Track and report customer complaints and satisfaction</li> <li>Use bundled product/service incentive systems</li> <li>Offer financing/leasing services</li> <li>Offer excellent customer training programs</li> <li>Invest in excellent employee training programs</li> </ul>

Source: Srivastava, R.K., T.A. Shervani, and L. Fahey (1999), "Marketing, Business Processes, and Shareholder Value," *Journal of Marketing*, (63, Special Issue), Adapted from Table 3, p.174.



## How customer satisfaction and process productivity combine

Increased customer satisfaction leads to at least three good outcomes; increased retention (that is, loyalty), increased sales per customer and, through word-of-mouth of satisfied customers, increased customer acquisition and sales. There can hardly be any argument here. We map and reduce supply process costs (without reducing the quality of the process output) because increased process productivity leads to reduced costs and increased profit margin per dollar sale. Again, surely no argument about this.

Now we come to the crucial point. Net Profits, the most useful marketing metric, come from sales (in dollars) multiplied by profit margin (e.g., 20 cents per dollar sale). Thus, a process productivity improvement that reduces cost and increases profit margin has both an additive and a multiplicative effect on the increase in profit that results from a process improvement that increases customer satisfaction.

Assume that a company's dollar sales of a product are \$1,000,000 and its profit margin is 20 cents on every dollar sale so its overall profit is \$200,000 ( $1,000,000 \times \$0.20$ ). Further assume that customer satisfaction increases by 50% and as a result sales increase from \$1,000,000 to \$1,500,000, a 50% increase. Assume that at the same time process efficiency increases so that profit margin increases by 50%, from 20 cents to 30 cents on the sales dollar (30%). Does net profit earned of \$200,000 increase by 50% (\$100,000) as a result of a sales increase of 50% and a further 50% (\$100,000) as a result of process efficiency increases to a grand total of \$400,000? No it does not. It grows by more, to \$450,000 rather than \$400,000 and the following explains why. Sales are now \$1.5 million and the profit per dollar sale is 30 cents so the new profit is  $\$1,500,000 \times 0.3 = \$450,000$ . The increased satisfaction has a \$100,000 main effect and the increased process efficiency has a \$100,000 main effect. They also have an additional nonlinear interaction effect of \$50,000 on profit. One focus multiplies the returns on the other focus producing this additional 25% increase ( $0.5 \times 0.5 = 0.25$ ). In this way your thinking has to become a little nonlinear and more importantly what this teaches us is that the two necessary major skills required of a manager that interact in creating profits are:

1. Listening to, serving and satisfying the customer, and,
2. Becoming a skilled process/productivity thinker skilled at reducing the cost and increasing the margin of any process without hurting the quality of the output of the process.<sup>16</sup>

Historically, many company cultures have not encouraged both of these activities together. Most companies and their managers tend to focus on input costs or output value, not both at the same time! A recent study revealed that firms that focus on revenue expansion through quality do better than firms that focus on either cost reduction efficiencies or on both quality improvements and cost reduction efficiencies.<sup>17</sup> When managers are provided with high quality customer satisfaction metrics, cost and profit metrics and marketing process metrics, and are better trained to use the metrics perhaps they will learn to manage both quality improvements and costs at the same time and manage both more profitably. To this purpose, the next Chapter defines and discusses customer satisfaction metrics and customer profitability and the third Chapter defines and discusses profit and cost metrics.

<sup>16</sup> Dickson, P. R. (2003), "The Pigeon Breeders Cup: A Selection on Selection Theory of Economic Change," *Journal of Evolutionary Economics*, 13, 259-280; Dickson, P. R., Lassar, W.M., Hunter G., Chakravorti, S., (2009), "The Pursuit of Excellence in Process Thinking and Customer Relationship Management," *Journal of Personal Selling and Sales Management*, 29(2), 111-124.

<sup>17</sup> Roland T. Rust, Christine Mooreman and Peter R. Dickson, "Getting Return on Quality: Revenue Expansion, Cost Reduction, or Both," *Journal of Marketing*, 66(4), 2002, 7-24.



## Study Questions

1. Modern management accounting is about ever-improving customer-focused processes.  
a) **True**   b) False
2. Increased process productivity leads to reduced costs and increased margins per dollar sale.  
a) **True**   b) False
3. Productivity improvement has only an additive effect on profitability.  
a) True   b) **False**
4. Which of the following statements are true and which are false?
  - a) Increased customer satisfaction increases sales volume.  
a) **True**   b) False
  - b) Process improvement increases profit per sales dollar.  
a) **True**   b) False
  - c) Sales x profit per sales equals total profit.  
a) **True**   b) False
  - d) Increasing total profit increases shareholder value.  
a) **True**   b) False
  - e) Increasing customer satisfaction multiplies process improvement effects  
a) **True**   b) False
  - f) Process improvement multiplies increased customer satisfaction effects.  
a) **True**   b) False
5. The key business processes in marketing that drive shareholder value are the PDM processes, SCM processes and CRP processes.  
a) True   b) **False**
6. Score card management tracks customer acquisition, retention, satisfaction, employee morale and efficiency, process efficiency, cash-flow, contribution margins, return on investment and shareholder value.  
a) **True**   b) False
7. Which of the following statements is correct:
  - a) Supply metrics drive process metrics that drive demand metrics.
  - b) **Process metrics drive supply metrics and demand metrics.**
  - c) Demand metrics drive supply metrics that drive process metrics.
8. Where do each of the following sets of measures fit in the Balanced Scorecard Framework:
  - a.) Owner outcome measures
  - b.) Learning and change measures
  - c.) Key internal business process measures
  - d.) Customer outcome measures

At the top       **B**    
 In the middle     **C**    
 Bottom left       **D**    
 Bottom right      **A**



## Marketing Accounting Metrics

# Chapter 2. Satisfaction, the primary demand metric

In 1980 the founder of J.D. Powers, Dave Powers, was hooted down by Pontiac executives when he explained the quality-satisfaction-market-share growth success of the Japanese competition; and that if General Motors (GM) and particularly its Pontiac Division did not respond to the voice of the customer, its market share would decline dramatically from 48% to the low 30s.<sup>1</sup> Nine years later in 1989 GM's share had slipped to under 33%. Yet when Mr. Powers gave another talk to GM executives, he faced the same defensive negativity of a decade before. This negative attitude cost tens of thousands of jobs and forever hurt the reputation of GM brands. But the story has a brief happy turn. By 1995 and 1996 GM had worked closely and successfully with J.D. Powers to dramatically turn around customer satisfaction and win several quality awards. The lesson to be learned here is that the biggest of companies can bootstrap their customer satisfaction up quite quickly even if it is too little, too late to be able to ever regain much of the market-share lost. This is because other brands have also greatly improved their quality and customer satisfaction. GM's share of the North American market has continued its fall from 28% in 2000 to 24% in 2007<sup>2</sup> and under 20% in 2011.

When satisfaction rankings improve, shareholder value increases. J.D. Powers asked a simple question (and J.D. Powers knows a lot about asking the right question) "How satisfied are you with your overall ownership experience, including product quality and dealer service quality?" They placed each automobile brand into three groups, low, medium and high customer satisfaction. Between 1998 and 2003 high satisfaction brand sales increased by 40% and low satisfaction brand sales dropped. More impressively the brands that between 1994 and 1999 improved their satisfaction ranking by more than three ranks (for example, from 10<sup>th</sup> best in their category to 4<sup>th</sup> best in overall customer satisfaction) increased their shareholder value from 1999 to 2004 by an average of 52%. In contrast, those whose rankings declined by more than three ranks suffered, on average, a painful 28% decline in shareholder value. Owners lost 28% of their capital because their customers were increasingly dissatisfied.

Companies, large or small, that do not focus on customer satisfaction are much more likely to fail. It must be taken seriously. Enterprise Rent-A-Car has publicly admitted that it was one of many U.S. companies that has paid lip-service to customer satisfaction but that all changed when innovative senior managers decided to block promotions in a group or region, if the groups' customer satisfaction scores fell below the company average. By linking rewards and promotions to customer satisfaction scores, now managers sat up and took notice of customer satisfaction and did something about it. Manager operating reports now give equal billing to customer satisfaction as they do to profit and growth. When customer satisfaction determines promotions, bonuses and salary, managers go to bed at night thinking about customer satisfaction. It is that simple.

One of the most important recommendations of J.D. Powers is to follow Southwest Airlines' example of hiring customer empathetic people. Hire people who in J.D. Powers' words "were born to be helpful." And keep them by paying them well. You pay peanuts, you get bad employee attitude, bad customer service that leads to declining satisfaction, lower customer retention, lower sales which results in an even more negative company culture, mass firings that

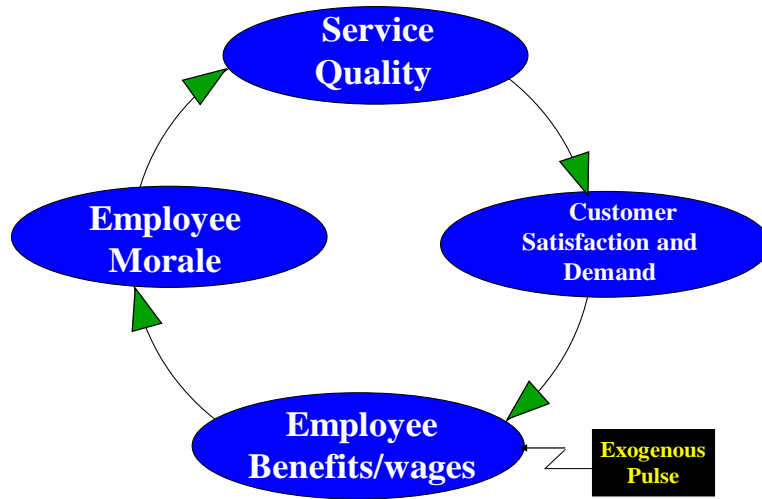
<sup>1</sup> The following paragraphs draw heavily on Denove, C. and Power, J.D. IV, Satisfaction: How Every Great Company Listens to the Voice of the Customer, *Penguin*, New York, 2006. We highly recommend this book from a leading expert in tracking customer satisfaction and using it in redesigning products and services.

<sup>2</sup> Taylor, A. "Gentlemen, start your Engines," *Fortune*, January 21, 2008, 74. GM went bankrupt in 2010.



further hurts employee attitudes, and thus, a vicious cycle is created between supply and demand (see Figure 2.1 below). It is a circular feedback effect between demand and supply that can as equally be turned positive where happy, well paid, well-rewarded, well informed employees such as those at Southwest Airlines or Costco increase the quality of customer service that increases customer satisfaction, customer retention and acquisition of referred customers. This, in turn, increases profits and shareholder value and employee rewards. This creates further employee enthusiasm and effort (see Figure 2.1 below). Understanding and tracking, over time, such circular feedback effects between various marketing metrics such as the supply side metrics, employee morale and service and product quality, and demand side metrics such as customer satisfaction, retention and acquisition are an important part of a marketing manager’s job.

**Figure 2.1**



This is vicious or virtuous circle depending on whether demand is increasing or decreasing. Management can trigger this feedback effect by giving the system a pulse such as giving employees a one time bonus for service improvement or negatively by reducing employee benefits.

**Measuring satisfaction**

Customer satisfaction metrics are used to focus manager attention on serving consumers and ensuring that they have a positive experience with the product or service. When tracked over time changes in customer satisfaction is a leading indicator of customer retention – satisfied customers will make further purchases in the future.<sup>3</sup> The standard way of measuring satisfaction uses a seven-point agreement with three measures such as below:

“I am completely satisfied with X” (the product or service purchased)						
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree or Disagree	Somewhat Agree	Agree	Strongly Agree
1	2	3	4	5	6	7
“I will purchase X (the product or service purchased) again”						
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree or Disagree	Somewhat Agree	Agree	Strongly Agree
1	2	3	4	5	6	7
“I will recommend X (the product or service purchased) to friends”						
Strongly Disagree	Disagree	Somewhat Disagree	Neither Agree or Disagree	Somewhat Agree	Agree	Strongly Agree
1	2	3	4	5	6	7

<sup>3</sup> Farris, P.W., Bendle, N.T., Pfeifer, P.E and Reibstein, D.J., Marketing Metrics: The Definitive Guide to Measuring Marketing Performance, 2<sup>nd</sup> Ed. *Prentice Hall*, New Jersey, 2010, 56.



Individuals who strongly agree that they are completely satisfied are very likely to be return customers, purchase the product again and even be a product or service evangelist and recommend the product or service to friends. The third measure above is bolded as the gold standard for measuring customer satisfaction because scores on this measure are always a little lower than the first two measures. This gold standard measure can also be used to identify promoters<sup>4</sup> by targeting the segment who score 6 or 7 on this measure with for example, a refer-a-friend-to-a-deal on a special referral deal website page. These metrics such as number or unique views, time spent on page, number of visits to page can be related to sales from which can be calculated the incremental contribution of each new referred customer's purchases. From the incremental contributions of all new sales can be calculated the increased net profit from short-term sales that the referral deal campaign produces. When the sustained increased net profit and net cash flow from referred customers over the longer term is measured then such increased cash flow can be discounted back and the additional added shareholder value that the campaign creates can be calculated. In this way we can directly link marketing metrics to key financial metrics, that is the percentage of customers who are likely to promote the product by word-of-mouth or on Facebook, to volume of new referred customer search at specific website pages, to the percentage of referred consumers who visit the site who purchase (conversion ratio) and from all the purchases-made can be calculated incremental sales growth, the contribution of the incremental sales growth from which can be calculated shareholder value creation. This is an example of how a number of marketing metrics are linked to crucial financial performance metrics.

### But first things first

But before surveying customers and tracking scores on these three measures and using them to target likely recommend to a friend promoters, firms should first track other simple metrics such as the number of complaint e-mails and product returns on the negative side, and unsolicited e-mails and letters from delighted customers on the positive side. The point is to not spend a lot of time and effort refining questions but instead start using and tracking several simple, common-sense measures now. To repeat, here is a list of customer satisfaction/dissatisfaction behaviors that the well-managed firm however large or small tracks and broadcasts across its organization:

1. Truly unsolicited letters and e-mails of thanks
2. Letters and e-mails complaining and reasons for returns ranked
3. Returns and reasons for returns ranked

These behaviors are initiated by customers. They are knocking at your door, in some cases banging on your door. Count them, pay attention to them, and provide superior customer service to them before you reach out and undertake customer satisfaction surveys, which are expensive. These customers are coming to you about their satisfaction rather than you approaching them to find out their satisfaction. Unsolicited letters, complaints and returns tell you very quickly a lot about customer satisfaction and dissatisfaction.

A common sense measurement process is to always ask an open-ended question as to how you could better satisfy your customers. Hotels have discovered that the number one driver of customer satisfaction is fast and efficient check in. They discovered this by asking customers how their service could be improved. Upgrades, knowledge of local restaurants and sites, and a pleasant décor are all well and good but it is fast and efficient check-in that is the real driver of customer satisfaction. It is the customer service process that has to be fixed first so that it is fast and efficient. The mistake that many companies make in efforts to improve their customer satisfaction is to try to improve too many things at once. The trick is to focus on the product or service features that most determine customer satisfaction.

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<sup>4</sup> Reichheld, Frederick F., "The One Number You Need to Grow," *Harvard Business Review*, 81 (12), 2003, 46–54.



For example, J.D. Powers has some very interesting advice on website design – keep it simple, intuitive to use. Ease of navigation around a web-site is the number one determinant of overall satisfaction with a web-site and web-site perceived quality. Think Google, the extreme example of simplicity and lack of clutter – not surprising as Google is the navigation expert. This is a general lesson about quality – do not use too many metrics – focus on the key quality measure or maybe two but not 10! Keep it simple by focusing on the most determinant quality metric and connecting serious manager rewards to improving performance on the most determinant quality metric.

## Measuring customer profitability

“A common conclusion is that a small group of customers who demand a disproportionate amount of ‘free’ support resources (e.g., after-sales service, customized products or shipping and credit terms) and order small volume or low-margin products, are unprofitable.” (p. 491)<sup>5</sup>

Do you prefer a large pile of cash to a small pile? Silly question, isn't it? Then should it not be just as obvious that if you run a business, or help run a business, you will prefer to focus your efforts on selling to customers whose business relationship will be highly profitable to you? The result is a larger pile of cash. We all need to think about this a bit right now and agree on this customer focus principle. If your job is to manage a business for its owners then your job is to increase shareholder value by increasing the average profitability of your customers and the number of your customers. The latter goal (increase the number of your customers) is set by senior managers, to make sure that average customer profitability is not increased at the expense of total profitability by simply getting rid of less profitable business!

The first step in such a customer focus is to identify the direct determinants (often called drivers) of customer profitability. They are:

1. Customer purchases high profit margin products and services,
2. Q the quantity of purchases made per year by the customer (size of the customer),
3. Low selling costs to the customer, low delivery costs, and low, after-sales service costs of customer.

The fourth, less direct, but still very important driver of customer profitability is the new profitable business a very satisfied customer brings to the company through referrals, recommendations and casual and explicit endorsement and promotion of your products and services on Facebook, by conspicuous consumption and word-of-mouth.

The second step is to redeploy resources so as to develop competences and competitive advantage around what you believe to be the key drivers of your customer profitability. Do you deploy resources so as to deliver the product they want, the way they want it at the time they want it to your potentially most profitable customers? If not, why not? Because you prefer a smaller pile of money? A sole proprietor, running a small business, observes closely his/her relationships with customers and develops an intuitive sense of what drives customer profitability. The entrepreneur then behaves accordingly. A more sophisticated, professionally managed firm develops a customer data-base. It then uses data-mining to identify customer profitability and future expected profitability, relate this profitability to product purchase mix and costs of doing business, and then develops profiles of profitable customer types.<sup>6</sup>

<sup>5</sup> Anderson, S.W., “Managing Costs and Cost Structure throughout the Value Chain: Research on Strategic Cost Management,” in C. S. Chapman, A. G. Hopwood and M. D. Shields (eds.), *Handbook of Management Accounting Research*, Vol. 2, *Elsevier*, Amsterdam, 2007, 481-506.

<sup>6</sup> Let  $\$x_{ji}$  be the profit a purchase of  $j$  company product by customer  $i$ . Total profit is traditionally measured as  $\sum_i \sum_j \$x_{ji}$  where customer purchases are first aggregated within products. But  $\sum_i \sum_j \$x_{ji} = \sum_j \sum_i \$x_{ji}$ . In this second term product purchases are first aggregated within customer. Profit made by summing the profit from all customers is the total profit of the firm. Thus, the relationship between customer profitability and firm financial performance does not need to be established empirically. It is an axiomatic relationship.



For example, by analyzing its data-base of customers, Best Buy was able to identify its most profitable customers (“angels”) and its least profitable customers (“devils”). The least profitable customers were those who kept returning merchandise, often purchased on sale. Best Buy enforced a re-stocking fee of 15% on all returns to discourage customers who made a habit of returning merchandise. The angels who tended to pay full price on higher quality electronics, consisted of five segments: technology enthusiasts, upper-income men, young family men, suburban mothers, and small business owners. Store managers were directed to analyze their local market, focus on two of these segments who were the largest in their local market, and cater to their needs by stocking their favorite merchandise and providing special in-store service for them. The strategic problem Best Buy faces is how to profitably serve and deal with the segment of shoppers who come to see and learn about the product and then buy online from the cheapest source.

The gambling conglomerate Harrah’s, famous for its customer data-mining and relationship management, identified its most profitable segment to be not the high rollers (they were too expensive to service and too few in number), but the heavy and frequent slot-machine players. Promotions focused at this most profitable segment, such as a frequent gambler card, were developed. In the early 2000s, long before it destroyed itself in the mortgage lending financial fiasco, ING launched an online-only savings bank that offered high interest rates of around 5% on savings accounts. It could do so because of the simplicity of its service and business model that resulted in operating costs less than one fifth of conventional banks. However, ING Direct also fired thousands of customers a year who were asking for special expensive services or making many costly-to-serve telephone calls a year and who did not have large saving accounts. This may sound a lot but the new bank had over two million customers and over \$30 billion in assets. On the positive side:

Continental Airlines launched a Customer Information System in the late 1990s where every one of its 40,000 gate, reservation and service agents have access to the history and value of the customer. An attached expert system also suggests remedies, perks such as upgrades and coupons for service delays. For their top customers they even know if they put on eye-shades when they go to sleep. As a result of this emphasis on higher service to the most profitable customers, the percentage of Continental customers who pay higher-cost unrestricted fares rose from 38% to 47%.<sup>7</sup>

Segmenting the market by customer profitability is best done using a customer data-base and data-base analysis that produces the metrics described in the following Table 1. You can generate a customer profitability measurement metric from Table 1 by adding up the “Yes” answers to the information reporting questions. A company or division with a score of 10 or more is practicing customer relationship management at a high level. A company with a score of 3 or less is a dinosaur when it comes to customer relationship management. Remember the system’s control maxim, the better you measure, the better you manage. The worse you measure, the worse you manage. The latter is the flying blind principle of marketing metrics. Reporting on the life-time value of a customer requires some sophisticated analysis that is presented in the S7-Customer Profitability worksheet.

### **Loyalty (retention) and profitability**

Loyal customers are usually much more profitable than new customers or switchers because they do not involve high acquisition costs, often pay a price premium, buy other products and services and generate referral business. The acid test of loyalty is the metric Willingness to search (%) = % of customers willing to delay purchase, reduce purchase or shop at another store to avoid substituting brands.<sup>8</sup> When this is high, profitability is high (see S8-Metric Relationships).

<sup>7</sup> Brady, Diane, “Why Service Stinks,” *BusinessWeek*, October 23, 2000: 124.

<sup>8</sup> Farris et al. 2010 op cit.



**Table 2.1**  
**A Process-Present Measure of Customer Profitability Measurement**

Only check the box if you are sure that the answer is yes.

- 1. Does the reporting system report results by SKU\*?..... \_\_\_\_\_
- 2-6 What? Sales..... \_\_\_\_\_
  - Returns..... \_\_\_\_\_
  - Average net selling price..... \_\_\_\_\_
  - Selling price range..... \_\_\_\_\_
  - Average contribution per SKU..... \_\_\_\_\_
- 7. Does the reporting system report costs per distribution activity/process... \_\_\_\_\_
- 8. Does the reporting system report channel sales?..... \_\_\_\_\_
- 9. Does the reporting system report channel profits?..... \_\_\_\_\_
- 10. Does the reporting system report individual customer profitability history? \_\_\_\_\_
- 11. Does the reporting system report trading/servicing costs by customer?.... \_\_\_\_\_
- 12. Does the reporting system report results by market segment?..... \_\_\_\_\_
- 13. Does the reporting system provide an estimate of the future  
 profitability of the customer or their life-time value?..... \_\_\_\_\_
- 14. Does the reporting system flag customer profitability to front-line  
 employees?..... \_\_\_\_\_
- 15. Does the reporting system flag customer service preferences to front  
 line employees?..... \_\_\_\_\_

\* SKU stands for stock taking unit. A specific model or item in a product-line is an SKU.

A study of the PC market found that higher levels of customer loyalty were related to higher sales growth rates and profitability (return on assets employed) <sup>9</sup>. A further study concluded that a higher retention rate leads to significantly increased profits in industries such as life-insurance, publishing, credit cards and auto service.<sup>10</sup> But another study of several other industries has suggested that the best customers are not always the loyal ones.<sup>11</sup> This is because sometimes long-standing customers in service industries can be more expensive to serve and often long-standing customers get more price discounts. They leverage their loyalty into a better deal rather than the selling company leveraging their loyalty into higher profit. It is what Harrah’s observed with High Rollers. Accordingly, the decision to invest in a customer relationship should be based on projected customer profitability and not the sales they generate. The way to strengthen the association between customer loyalty and customer profitability is to measure and manage both at the same time. For marketing management accounting, this is mostly focused on the profit margins of the product mix the customer buys, the amount they buy, the way they buy, the discounts they are given and the after-sales service they demand.

<sup>9</sup> Smith, R. E. and Wright, W.F., “Determinants of Customer Loyalty and Financial Performance,” *Journal of Management Accounting Research*, 16, 2004: 183. See also Anderson, E., Fornell, C. and Lehmann, D.R., “Customer Satisfaction, Market Share, and Profitability: Findings from Sweden,” *Journal of Marketing*, 58(July), 1994, 53-66.

<sup>10</sup> Reichheld, F.F., *The Loyalty Effect*, Harvard Business School Press, Boston, 1996.

<sup>11</sup> Reinartz, W. and V. Kumar, V., “The Mismanagement of Customer Loyalty,” *Harvard Business Review*, (July-August), 2002: 86-94. See also Reinartz and Kumar, “On the Profitability of Long-life Customers in A Non-contractual Setting: An Empirical, Investigation and Implications for Marketing,” *Journal of Marketing*, 64(October), 2002, 17-35.



## Focusing on servicing the needs of true friends

“True friends are the most valuable customers of all. They are satisfied with the existing arrangements with the company, and they are comfortable engaging with the firms processes they buy steadily and regularly (but not intensively) over time. They need consistent yet intermittent communication.”<sup>12</sup>

The IMA (*Institute of Management Accountants*) has funded a stream of splendid research undertaken by Professor V. Kumar, which has demonstrated the value of first identifying as objectively as you can from accounting records profitable customers and then focusing your marketing and selling campaigns around what they buy, how they buy and when they buy. In one study using a sample of customers the profit increase was in the tens of millions of dollars and if the same focus had been applied across all of the customers of the company, the profit increase would have been in the hundreds of millions.

Calculating the profitability of a customer is relatively easy. From accounting records come purchases, sale price and total cost of sale estimates. Price minus cost is the purchase's contribution margin and all these margins are added up for the sales period used. The cost includes all manufacturing, marketing and distribution costs including all sales calls, all allocated costs and special extra customer service costs such as special delivery costs. The total of all contribution margins from customer purchases is the value of the customer in that period. From period to period it may go up and down but if forecast over time and discounted back to a present value it becomes the present value of the customer. If measured over the lifetime of the customer, and the initial cost of acquiring the customer is deducted, then the result is the Lifetime Present Value of the customer (see *S7. Customer Profitability Analysis*).

The problem is predicting the future behavior of customers from their past behavior and other drivers of behavior, such as seasonal or religious purchasing. Here, big data analysis of massive databases of customers often has to be done to predict what, when and how past profitable customers will buy and designing customer service and direct selling around this prediction. But, over the next few years software and accounting systems will evolve to be able to do such data analysis inexpensively in industry sectors whose mix of customers is such that it will be very worthwhile to calculate and estimate CLV.

To keep CLV in perspective it is very simple logic. Identify your profitable customers and focus on this segment and its buying patterns with your product development, customer service and marketing campaigns. It also involves identifying customers who are predicted to be far less profitable, even unprofitable, and whose business needs to be discouraged (from benign neglect) and cost controlled in its servicing. This can be very difficult because limiting service and credit to such customers is very likely to be interpreted as bad service and the result may hurt brand reputation and brand equity. There will most certainly be a storm of customer service complaints inbound that the company must prepare to service. However, the alternative is to retain unprofitable customers who are eating up equity and shareholder value. That cannot be a rational alternative. But it requires measuring customer profitability with the same precision as product profitability is measured.

<sup>12</sup> Kumar, V., Using Customer Lifetime Value for Acquiring, Retaining and Winning Back Profitable Customers, *Institute of Management Accountants*, Montvale, N.J., 2014.

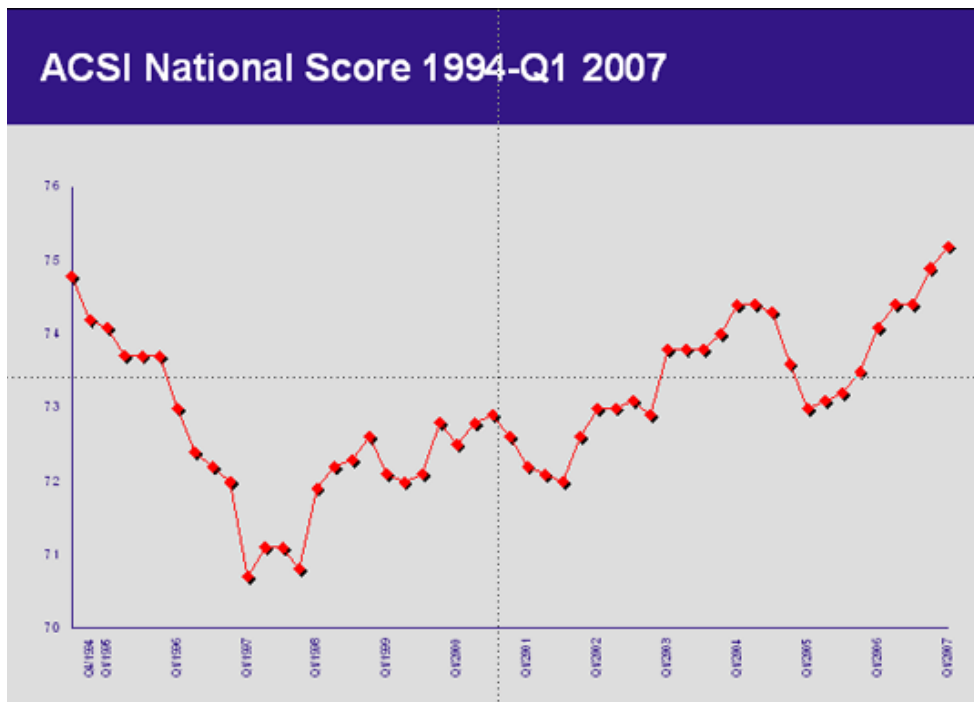


## Study Questions

1. The key determinant of marketing success is fussing about the best measurement of customer satisfaction.  
a) True b) **False**
2. Increased customer satisfaction is a major creator of capital.  
a) **True** b) False
3. When customer satisfaction determines promotion, managers go to bed at night thinking about customer satisfaction.  
a) **True** b) False
4. Understanding feedback effects between demand and supply metrics is an important part of a manager's job.  
a) **True** b) False
5. The well managed firm tracks and broadcasts across its organization which of the following:  
a) Truly unsolicited letters and e-mails of thanks  
b) Letters and e-mails complaining, ranking of complaints  
c) Returns and reasons for returns ranked  
d) b and c above  
e) **All of the above**
6. Which of the following statements about the customer service feedback effect is false?  
a) A decrease in employee benefits and wages leads to a decrease in employee morale  
b) An increase in employee morale leads to an increase in service quality  
c) An increase in customer satisfaction leads to increased rewards to employees.  
d) A one time bonus can trigger a positive feedback effect  
e) **A feedback-effect always produces positive outcomes.**
7. Companies should always be asking customers how they could better satisfy them.  
a) **True** b) False
8. The visual graphics that engage you is the number one determinant of overall of web-site satisfaction.  
a) True b) **False**
9. There are four major drivers of customer profitability.  
a) **True** b) False
10. Long standing, loyal customers can be more expensive to serve and often get more price discounts.  
a) **True** b) False
11. Companies should track both customer satisfaction and loyalty because they do not always have the same effect on profitability.  
a) **True** b) False



## Case 1 Hyundai's Miracle Performance



**Source:** ACSI. To learn more please Google ACSI.

The University of Michigan American Customer Satisfaction Index (ACSI) started high in 1994 and then took a dip during 1997-1998. Since then it has climbed fairly steadily back to its original level. If we expect satisfaction to increase over time because marketing is successful at increasing customer satisfaction then, overall, this is a disappointing result. On a more positive note, research based on the ACSI has established the link between an increased ACSI score and company share value.<sup>13</sup> Customer satisfaction creates capital.

Over the 44 Industries studied by ACSI, the company that made by far the largest progress in increasing customer satisfaction between 1994 and 2006 was the South Korean automobile company Hyundai. Its satisfaction rating jumped from 68 in 1994 to 84 in 2006 ... a 24% increase! Honda's rating in 2006 was 86. Toyota's rating in 2006 was 87. Hyundai has made huge progress in its product innovation, product quality, service quality and in satisfying its customers. It is a great and rare success story. How did Hyundai lift its customer satisfaction? It hired J.D. Powers to analyze customer dissatisfaction. The first reports were presented to low level managers who were not interested in the "bad news", blaming it on U.S. sales staff and women drivers! These managers believed that the car price was so low that quality did not matter. It did. When J.D. Powers presented another negative report to Hyundai in 1996 it was to Chairman Chung who was unaware of the Powers' previous studies and the reasons behind the sales decline. The result was a sea change in company culture as the company responded to the top down direction to pay attention to the voice of the customer and to fix the quality problems. Quality greatly improved, sales quadrupled and now loyal customers buy Hyundai cars because they want one and not because it is the only new car they can afford.

<sup>13</sup> Fornell, C., Mithas, S., Morgeson, F.V. and M.S. Krishnan, M.S., "Customer Satisfaction and Stock Prices: High returns, Low Risk," *Journal of Marketing*, 70(January), 2006, 3-14.



## Hyundai Case Study Questions

1. The Hyundai case study teaches us that there is a relationship between price and quality and if the price is low enough consumers expect the quality to be low and really do not care about quality.  
a) True   b) **False**
2. The problem with Hyundai was that the middle level executives were very keen to improve quality but senior management stood in the way of such efforts.  
a) True   b) **False**
3. When senior management focuses on customer satisfaction, listens to the customer and redesigns the product to increase customer satisfaction it is preaching rather than practicing customer orientation.  
a) True   b) **False**
4. It took a very persistent consultant for Hyundai to become customer satisfaction oriented.  
a) **True**   b) False
5. In 2 years Hyundai improved the quality of its cars and service by 24% almost to the level of Toyota and Honda.  
a) True   b) **False**
6. The national customer satisfaction score has increased by over 5% over the last 10 years.  
a) **True**   b) False



## Marketing Accounting Metrics

# Chapter 3. Cost, the primary supply metric

It is a fact that it is easier to control and manage business costs than it is to control and manage consumer demand for company products and services. The reason is that consumer demand is also influenced by other factors quite beyond a firm's control, such as competitors' market behavior and the state of the economy. An important principle of marketing systems control and its metrics is therefore to first master cost control. This requires a good understanding of cost and profit metrics and what their implications are for bottom-line profitability. Without a good understanding of the cost of the programs that the marketer is proposing, s/he is both unsure of demand and also his/her supply costs - which is a double whammy and a recipe for disaster. It is a double jeopardy. It is therefore a case of self-imposed organization blindness to hire executives who do not understand the cost and profitability of what they are talking about.

Let's look at it another way. Can you imagine proposing a marketing campaign, a marketing tactic or a marketing strategy to a senior executive and not being able to answer questions such as: What is it going to cost? How could we save costs? What do sales have to be to get a 20% return on the campaign investment? You would look like something close to an idiot ...and a lot of marketing executives unfortunately have. It is one of the reasons why, as already mentioned in Chapter 1, marketing executives have lost standing in their companies and why the influential McKinsey Consulting group started recommending downsizing and even doing away with Marketing Departments in the mid-1990s!

Marketing has become too soft a discipline. Too many marketers and sales managers do not understand enough management accounting and how to create and use financial spreadsheets to be able to answer questions about campaign costs and profitability, product costs and profitability, channel and trade customer service costs and profitability, and finally, end customer costs and profitability. It's not that hard. You start with variable costs.

### Variable costs

Variable costs vary with the quantity sold ( $Q$  in economics). Variable costs are also sometimes called direct costs -- as in directly connected to quantity sold. An example is salesperson commissions. If salespeople get a 5% commission on a product that sells for \$100, then this is a variable cost of \$5 for every unit sold. Thus, the variable sales cost per unit sold is \$5.

Examples of variable costs are the direct costs of materials used in the product, including the cost of all components (such as a screen for a laptop) and the direct costs of labor used in making, assembling or providing a service. Variable distribution costs are costs such as the UPS cost of delivery per unit. Other examples of variable costs are:

- After-sales service costs/unit = proportion of total quantity sold that will need servicing (this is a defect rate)  $\times$  (multiplied by) the average cost of service per unit
- Coupon redemption cost/unit sold = proportion of total quantity sold that are redeemed (this is the coupon redemption rate)  $\times$  the average cost of processing each coupon redemption
- Rebate redemption cost/unit sold = proportion of total quantity sold that are redeemed (this is the rebate redemption rate)  $\times$  the average cost of processing and fulfilling each rebate redemption.
- Cost of each product's packaging
- Import/export duties



Price and variable cost/unit are used to calculate the all important contribution per unit sold which is one of the most important marketing accounting metrics.

Contribution per unit sold = Price per unit sold - variable cost per unit sold

Contribution margin % = (Price per unit sold - variable cost per unit sold)\*100/Price per unit sold

Gross (Total contribution) = Contribution per unit sold \*  $Q_{time}$

## Fixed costs

One way of thinking about fixed costs is that they are all costs other than the variable costs. They are fixed in that they do not vary with sales. For example, the cost of an ad campaign does not usually vary with actual sales, unless it is search advertising on Google and each search drives online sales. There are often costs associated with managing distribution, marketing and manufacturing that are fixed such as management salaries, office rentals, photocopying, utilities, legal costs, accounting costs (all of these costs are sometimes called overhead costs shortened to “overheads”), depreciation or rental of equipment, computers, vehicles; market research studies, product and service R&D, maintenance of websites, sales-training, sporting event sponsorship, public relations campaigns. All of these fixed costs have to be recovered before the company starts to make a profit.

### Explanation why the following costs are fixed or variable

Advertising campaign cost	Fixed – does not vary with quantity sold (Q)
Cost of Marketing Coupons to consumers	Fixed – does not vary with Q
Coupon redemption cost	Variable – $CRC = Q \times \text{proportion of } Q \text{ that used coupon} \times \text{redemption cost of coupon}$
Salesperson commission on sales	Variable as it varies with Q
Sales manager salary	Fixed – does not vary with Q
Cost of applying for patent	Fixed – does not vary with Q
Royalty paid to patent holder	Variable – varies with Q
Costs of product packaging	Variable – varies with number of packages sold (Q)
Delivery costs of orders to merchants	Variable – varies with size and number of deliveries
Marketing overhead costs	Fixed, paid or committed up-front
After sales service costs	Variable – $Q \times \text{average cost of service call} \times \text{proportion of } Q \text{ that involved a service call.}$
Import duties	Variable – they are paid per item imported

## Sunk costs, common costs and incremental costs

The Empire State Building is 1,454 feet tall including a 204 foot tower. A new 410 foot tower twice the size of the current tower is being considered that would increase the height of the Empire State Building to 1,660 feet. How much taller will the building now be? Do you subtract 1,454ft from 1660ft to work out the difference? You could, but a simpler way is to subtract the height of the old tower 204 ft. from the new tower 410ft and get 206ft. Similarly, in making a financial decision only consider the marginal unique costs of each option. Costs that are common across all options do not need to be considered in the decision, and they add unnecessary complexity to the decision. The same applies when comparing costs of different strategies and options. The following sunk costs are a special type of common cost:

Assume that you have spent \$400 on a non-refundable ticket for a weekend trip to Michigan. Several weeks later you buy a \$200 ticket for a weekend ski trip to Wisconsin. You think you will enjoy the Wisconsin ski trip more than the Michigan ski trip because you will be with friends you like more. As you are printing off your non-refundable ticket to Wisconsin you notice that the Wisconsin trip is for the same weekend as the Michigan trip. It's too late to sell



either ticket, and you cannot return them. You must use one ticket and neither use nor redeem the other.

Which trip would you go on? In one study more than half of the students chose the Michigan trip.<sup>1</sup> They considered the irrelevant sunk cost. Even one third of students in an economics class, where sunk cost was explained, chose the Michigan trip. The rational decision is to consider that you have sunk \$600 into taking either trip. The common cost is \$600. Which will deliver the most benefit for \$600? The Wisconsin trip, so you should take it. You do have to always account for common costs in your P&L (Profit & Loss) statement that calculates overall profitability, but not in your decision-making between options that share the common (sunk) costs.

## Allocating costs

A principle and goal of marketing accounting is to assign as many costs as possible directly to a product/service when measuring product/service profitability, and to the individual customer when measuring individual customer profitability. In the past many costs were treated as general overhead costs and allocated to departments, processes, products/services or customers, in an arbitrary way such as in proportion to sales, labor costs or some other metric. The following Table 3.1 presents a spreadsheet that illustrates how costs are allocated by sales and by physical production quantity (gallons). The differences in calculated product profitability are substantial.

Such arbitrary allocation of joint costs opens up the allocation process to organization politics because managers try as hard as they can to have as little of these joint costs allocated to their budget as possible! Not only does this process distort actual costs and lead to unfairness, but it also wastes a lot of time and can lead to bad feelings between managers, which reduces collaboration and cooperation. Rather than arbitrarily allocate costs based on sales, quantity produced or labor costs, as is often practiced, why not measure actual costs and allocate them? For example, in the Cost Allocation Table 3.2 below, when marketing costs are allocated directly, rather than as a proportion or percentage of sales, the OEM market operating margin jumped from 2% to 9%.

The profitability of a customer can be computed by first computing the average profit of each product or service sold to that customer. The amount and mix of product purchases made by the customer will then determine customer profitability. But maybe one customer is more costly to sell to and service than another. Perhaps costs can be assigned directly to a specific customer rather than averaged over all customers. If so, then how should this be done? How do you assign costs to a product, service and customer? As explained in Chapter 1, you must study the processes and activities involved in making and marketing a product. Table 3 below presents an example of a Bank's activities, and measures of the activities that determine/drive costs.

How do you determine the cost of an activity? Consider a company that spent \$6,000,000 in the last year on customer service, and based on interviews with management and work diaries, it is estimated that 75% of the time of the customer service department is spent handling customer orders, 10% on customer credit checks, and 15% on customer complaints. During this year there were 100,000 customer orders, 10,000 complaints and 20,000 credit checks.

The cost driver rate for handling a customer order is 75% of \$6,000,000 which is \$4,500,000 divided by 100,000 customer orders which equals \$45/order. The cost driver rate for handling a customer complaint is 15% of \$6,000,000 which is \$900,000 divided by 10,000 which is \$90/customer complaint. The cost driver rate for a customer credit check is 10% of \$6,000,000 divided by 20,000 credit checks which is \$30/credit check.

<sup>1</sup> Arkes, H.R. and Blumer, C., "The Psychology of Sunk Cost," *Organizational Behavior and Human Decision Processes*, 35, 1985, 124-140.



**Table 3.1**  
**Allocating Costs to Products and Services**

Joint costs of 110,000 gallons raw milk and processing to split-off point	\$600,000		
	<b>Cream</b>	<b>Skim</b>	<b>Total</b>
Beginning inventory in gallons			
Gallons produced	50,000	150,000	200,000
Gallons sold	40,000	60,000	100,000
Gallons inventoried	10,000	90,000	100,000
Selling price per gallon	\$8	\$4	
<b>Allocation based on:</b>			
Sales value of total production at splitoff point	\$400,000	\$600,000	\$1,000,000
Weighting by sales value	0	1	
Allocation of costs	\$240,000	\$360,000	
Joint production cost per gallon	\$4.80	\$2.40	
<b>Allocation based on:</b>			
Physical-measure of total gallons produced	50,000	150,000	200,000
Weighting by gallons produced	0	1	1.00
Allocation of costs	\$150,000	\$450,000	\$ 600,000
Joint production cost per gallon	\$3	\$3	\$3
<b>Income statement Using Sales Value Allocation</b>			
Revenues	\$320,000	\$240,000	\$560,000
Cost of goods sold (joint cost)			
Production costs	\$240,000	\$360,000	\$600,000
Less ending inventory	\$48,000	\$216,000	\$264,000
Cost of good sold	\$192,000	\$144,000	\$336,000
Gross margin	\$128,000	\$96,000	\$224,000
Gross margin percentage	<b>40%</b>	<b>40%</b>	<b>40%</b>

*Remember that other direct costs associated with Cream and Skim have to be deducted to calculate final margin for each*

<b>Income statement Using Physical-measure Allocation</b>			
Revenues	\$320,000	\$240,000	\$560,000
Cost of goods sold (joint cost)			
Production costs	\$150,000	\$450,000	\$600,000
Less ending inventory	\$30,000	\$270,000	\$300,000
Cost of good sold	\$120,000	\$180,000	\$300,000
Gross margin	\$200,000	\$60,000	\$260,000
Gross margin percentage	<b>63%</b>	<b>25%</b>	<b>46%</b>

*If the joint cost of production is actually a cost that can be directly connected to gallonage produced then this is the appropriate way of allocating the joint cost.*

**Source:** The above spreadsheet is an adaption of an example from Horngren, C.T., Datar, S.M. and Rajan, M.V., *Cost Accounting: A Managerial Emphasis*, 14<sup>th</sup> ed. Boston, Prentice-Hall, 2012.



**Table 3.2**  
**Cost Allocation Distortions**

	Contract	Industrial Suppliers	Government	Original Equipment Manufacturers	Total
Annual sales (\$000s)	\$79,434	\$25,110	\$422	\$9,200	\$114,166
Less variable product costs	\$52,426	\$14,815	\$325	\$6,716	\$74,208
Gross contribution	\$27,008	\$10,295	\$97	\$2,484	\$39,958
Gross margin %	34%	41%	23%	27%	35%
SG&A Allocation(@25% of \$sales)	\$19,859	\$6,278	\$106	\$2,300	\$28,542
Operating profit	\$7,149	\$4,018	-\$8	\$184	\$11,417
Operating Margin	9%	16%	-2%	2%	10%
Investment allocation @ 42% of \$sales	\$33,362	\$10,546	\$177	\$3,864	\$47,950
Return on Investment	21%	<b>38%</b>	-5%	5%	24%

**New Allocation of Selling, General and Administrative Expenses**

	Contract	Industrial Suppliers	Government	Original Equipment Manufacturers	Total
Annual sales (\$000s)	\$79,434	\$25,110	\$422	\$9,200	\$114,166
Less variable product costs	\$52,426	\$14,815	\$325	\$6,716	\$74,208
Gross contribution	\$27,008	\$10,295	\$97	\$2,484	\$39,958
Gross margin %	34%	41%	23%	27%	35%
Less directly charged marketing expenses:					
Commission	\$4,682	\$1,344	\$12	\$372	\$6,410
Advertising	\$132	\$38	\$0	\$2	\$172
Co-op advertising	\$416	\$120	\$0	\$0	\$536
Catalog	\$504	\$160	\$0	\$0	\$664
Sales promotions	\$394	\$114	\$0	\$2	\$510
Warranty	\$64	\$22	\$0	\$4	\$90
Sales administration	\$5,696	\$1,714	\$20	\$351	\$7,781
Cash discount	\$892	\$252	\$12	\$114	\$1,270
Total	\$12,780	\$3,764	\$44	\$845	\$17,433
Administrative Overhead	\$8,161	\$2,131	\$36	\$781	\$11,109
Operating profit	\$6,067	\$4,400	\$17	\$858	\$11,416
Operating Margin	<b>8%</b>	<b>18%</b>	4%	<b>9%</b>	10%
Investment allocation @ 42% of \$sales	\$33,362	\$10,546	\$177	\$3,864	\$47,950
Return on Investment	<b>18%</b>	<b>42%</b>	10%	<b>22%</b>	24%

The marketing costs to the OEM segment were actually much lower than previously estimated. It makes this segment look more attractive as a future growth market. But, as of now, every investment dollar should go to the most profitable segment by far, the Industrial Supplier segment. It's a do you prefer a big pile of money or small pile of money choice: which would you choose? You increase investment in the IS segment.

**Source:** Based on an example from Robin Cooper and Robert S. Kaplan, "Measure Costs Right: Make the Right Decisions," *Harvard Business Review*, September-October, 1988, p. 96-103



**Table 3.3**  
**Bank Activities and Activity Cost Drivers<sup>2</sup>**

<b>Activity</b>	<b>Activity Cost Driver</b>
Provide ATM service	Number of ATM transactions
Clear debit items	Number of debits processed
Branch operations for debit items	Number of over the counter branch debits
Issue personal check book	Number of books issued
Clear credit items	Number of credits processed
Lending control and security	Number of interventions
Handle customer inquiries	Minutes of telephone call time
Open new accounts	Number of accounts opened
Close accounts	Number of accounts closed
Computer processing	Number of computer transactions
Statements and postage	Number of statements sent
Investment/insurance advice	Minutes of advice provided
Process VISA transactions	Number of VISA transactions
VISA statements	Number of VISA statements sent
Administer mortgages	Number of mortgages maintained

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<sup>2</sup> From Atkinson, A.A., Kaplan, R.S., Matsumura, E.M. and Young, S.M., *Management Accounting*, 5<sup>th</sup> Ed. New Jersey, 2006, Prentice-Hall, 160.



Notice that handling a complaint is twice as expensive as handling an order. These cost drivers can then be used to charge customer service costs directly to products, customer segments and individual customers. It really is not that complicated; however management accounting research has found that for many companies it seems too complicated and is judged not worth the effort:

Although ABC [Activity Based Costing] is very attractive from a conceptual point of view and it has been included in all management accounting textbooks and most business school curriculum, surveys have shown that it has not been considered by the majority of organizations and that it has been abandoned by many organizations that had sometime in the 1990s decided to adopt it and implement it....Research on the impact of ABC on performance has shown that the implementation of ABC does not clearly improve performance and firm value.<sup>3</sup>

Despite all of the text-books, articles, software and seminars on ABC, companies are not adopting it and some are even abandoning it. Why it has not delivered is not understood. One plausible reason is that the company culture cannot adopt ABC or use it effectively because the end users of ABC, managers in general, are not adequately trained in activity and process thinking to use ABC confidently and effectively. The point is that cost management is more than just learning how to measure costs. It also involves thinking strategically about what drives costs lower.

### Quality and cost experience curves

The two figures below (Figures 3.1 and 3.2) present the effect of experience on quality defects and labor hours required to produce a jet plane.<sup>4</sup> It is very clear that by learning-by-doing, costs can be reduced and quality increased. The latter is very important for medical procedures where it has been repeatedly demonstrated that hospitals with medical teams with a lot of experience in a surgical procedure have much lower mortality rates.<sup>5</sup> Always ask how many of the same operation your specific surgical team has done before! Cost reductions and quality improvements come from several types of learning. The activities within processes or procedures are learned by implementers first through training, and then by on the job learning-by-doing. They are modified and then honed to a high level of skill. As the process is bedded down, the product, service and process is also often redesigned by engineers to reduce costs and defects. It becomes simplified through innovative shortcuts or the use of new technology. The process continues to be refined by small and large innovations suggested by process workers and by engineers overseeing the whole process. Even customers or suppliers contribute to taking the costs and defects out of your product. In addition, cost accounting is used to evaluate product design changes that reduce costs, and is also used to evaluate how to reduce manufacturing and distribution costs. The stronger the focus on reducing costs, the faster a firm's progression down the experience curve. Such study of costs has become known as strategic cost management. Furthermore, with experience, an economy of scale feedback dynamic often develops that spurs on further cost reduction efforts, as described in Figure 3.3 below. Creating such a dynamic is a very sound strategy.

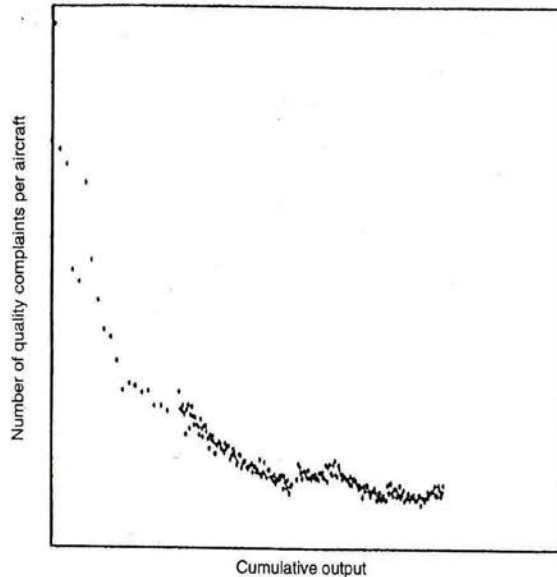
<sup>3</sup> Gosselin, M., "A Review of Activity Based Costing: Technique, Implementation, and Consequences," in Christopher S. Chapman, Anthony G. Hopwood and Michael D. Shields (eds.), *Handbook of Management Accounting Research, Vol. 2*, Elsevier, Amsterdam, 2007, 666.

<sup>4</sup> From Argote, L., "Group and Organizational Learning Curves: Individual, System and Environment Components," *British Journal of Social Psychology*, 32, 1993, 31-51. In this section we also draw on Adler, P.S., and Clark, K.B., "Behind the Learning Curve: A Sketch of the Learning Process," *Management Science*, 37(3), March, 1991, 267-282.

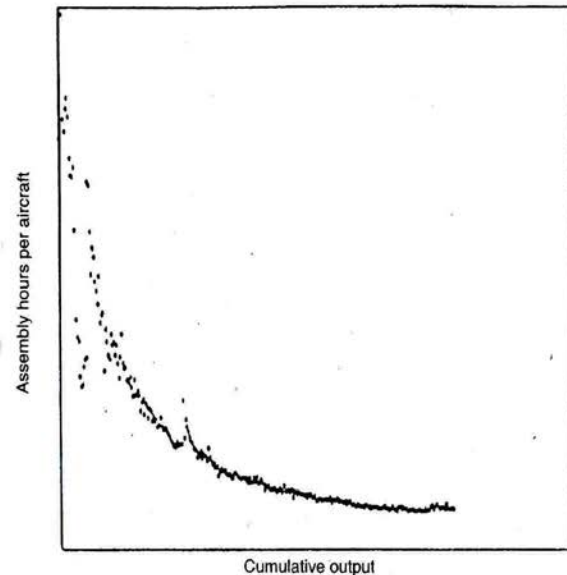
<sup>5</sup> See for example, Jollis, J.G., et al., "The Relation Between the Volume of Coronary Angioplasty Procedures at Hospitals Treating Medicare Beneficiaries and Short-Term Mortality," *New England Journal of Medicine*, 331(24), 1994, 1625-1629.



**Figure 3.1**  
**Number of Defects**



**Figure 3.2**  
**Cost**

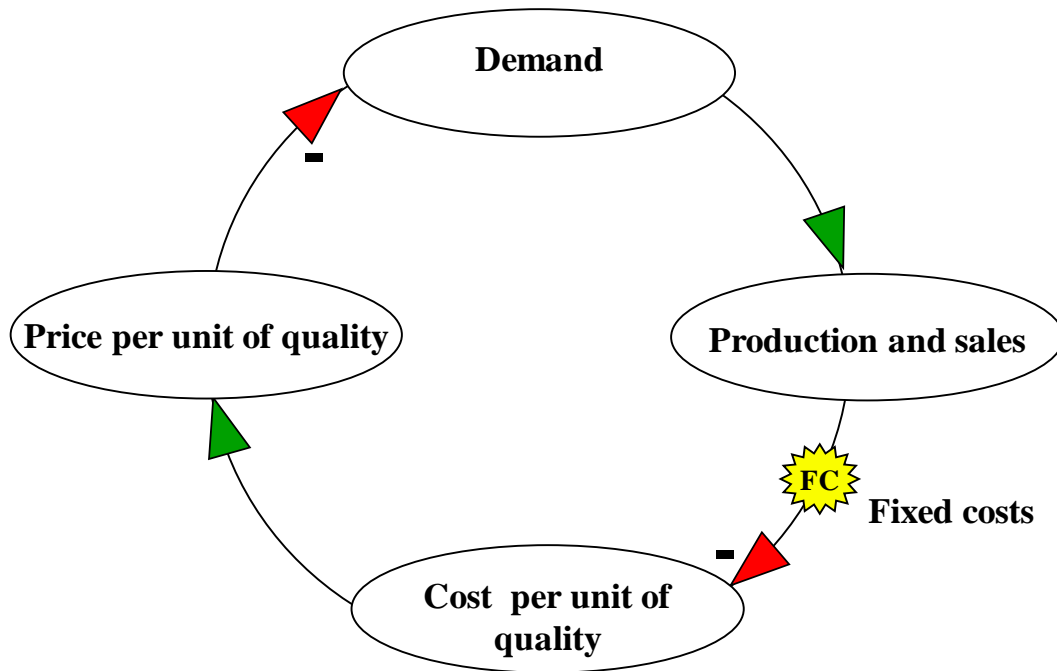


As sales and production increase, average cost declines because fixed costs are shared across a larger  $Q$ , price can be lowered, and sales and production further increase. The problem with such process improvement is that when a completely new innovation comes along requiring a very different production and distribution process, you have to start all over again; the old product and process, however efficient, are replaced by the new product and production process. Often firms are slow to make such changes. For example, Kodak was far too slow in moving from film camera production and film production that it was extremely good at, to the manufacturing and marketing of digital cameras where none of its film competitive advantage existed. Similarly, Polaroid was way too reluctant and slow in moving from its patented instant photography technology to the new digital instant photography. It also went bankrupt.

It can be hard to let go of the old and familiar. The lesson from experience curve research is that costs should go down and quality up as a firm's manufacturing and distribution systems are bedded down with experience and cumulative sales. The way to reduce costs is to eliminate them through clever product and process design and to increase worker productivity through training, learning-by-doing and listening to their suggestions. Dell Computers had for decades been an innovator in process efficiencies, in mail-order and online selling processes, in distribution processes and in product assembly processes. Year after year it increased worker productivity, reducing manufacturing and distribution space needed. This ability to reduce costs led Dell to initiate major price reductions in PCs: first under \$2,000, then under \$1,500, then under \$1,000 and now around \$500. The industry had to follow Dell's prices down and several have struggled to survive because they were not as process competitive as Dell and other rivals. Even Dell has struggled to maintain its profitability. Its increased volume of business did not nearly compensate for the reduced unit margins that resulted from the price reductions (See the Changing Price spreadsheet).



**Figure 3.3**  
**A Cost Feedback Effect**



As production and sales increase, cost/unit decreases because fixed costs are spread across more sales and also more experience reduces costs. As cost/unit decreases, in a competitive market price/unit decreases. As price per unit decreases demand increases. As demand increases, sales and production increase. This virtuous circle can turn in the opposite direction into a vicious circle when sales and production decrease.



## Study Questions

1. Please indicate which of the following costs are fixed and which are variable with a V or F beside each cost:

- F Advertising campaign expenses
- V Google search/click costs
- F Costs associated with marketing coupons to consumers
- V Coupon redemption cost paid to retailers
- V Salesperson commission
- F Sales manager's salary
- F Cost of applying for a patent
- F Cost of designing packaging
- V Royalty paid to patent holder
- V Cost of product packaging
- V Delivery costs of orders to merchants
- F Marketing overhead costs
- V After-sales service costs
- V Import duties
- F Cost of a salesperson's car
- V Product usage instruction booklet
- V Cost of a warranty program

2. Allocation of overhead costs:

- Is subject to organization politics. a)  True b)  False
- Creates cost distortions. a)  True b)  False
- Can lead to increased cooperation. a)  True b)  False

3. The best way of assessing the profitability of a customer is to first compute the average cost of an item sold and hence its average profitability, and then multiply this product item profitability by the amount of the product that each customer buys. The mix of product purchases by the customer will then help determine customer profitability.  
a)  True b)  False

4. Please check all of the following costs that cannot be charged to individual customers through the products they purchase:

- Product manufacturing components and materials
- Product material and component ordering, handling and inventory costs
- Product manufacturing labor costs
- Product manufacturing machine costs
- Product defect reworking/disposal costs
- Product end-of-life take-back and disposal costs
- Supervisor and engineer costs fixing product manufacturing process
- Product packaging costs



- Costs of holding product inventory  
 General overhead  
 Product freight costs  
 Picking, packing and loading product costs  
 Product return freight, handling, recycling/disposal costs  
 Product warranty/replacement costs  
 Product after-sales service visit costs  
 Product after-sales service telephone contact costs  
 Product after-sales online service contact costs  
 Product order receiving and processing costs (by internet, phone or in-person)  
 Product credit terms costs  
 Product slow payment collection costs  
 Product bad debt costs  
 Product selling costs  
 Product advertising costs  
 Product research and development costs  
 Time spent by management on managing product
5. Sunk costs are common costs.  
a) **True**    b) False
6. Common costs have to be considered in financial reporting of results but should not be used in decision making.  
a) **True**    b) False
7. Activity Based Costing (ABC) is growing in popularity.  
a) True    b) **False**
8. Every time a new product or service is introduced, it takes a while for a company to learn to make it efficiently.  
a) **True**    b) False
9. Helen is full time business student and needs to decide if she will attend a four week summer session that costs \$1,000 or take a break from school and work making \$400 a week. What is the opportunity cost of attending the four week summer session?  
a) \$1,000  
b) \$1,600  
c) \$600  
d) **\$2,600**
10. \_\_\_\_\_ is sales minus variable expenses  
a) Revenue  
b) Margin on  
c) **Contribution** margin  
d) Fixed cost recovery
11. Acme Products sales are \$65,000, variable expenses \$39,000, Total fixed costs \$12,000. What is the contribution margin percentage?  
a) 17%  
b) 20%  
c) 9%  
d) **40%**



12. Acme Products budgets sales of \$50 million, variable expenses \$45 million, Fixed Costs \$3 million. Calculate the new expected net profit if there is a 33.3% increase in fixed costs and a 10% decrease in variable expenses.
- \$8,300,000
  - \$5,500,000**
  - \$3,500,000
  - \$(3,500,000)
13. Beta Products manufactures B1 at a cost per unit of 5,000 unit quantity of Direct Materials \$4/unit, Direct labor \$10/unit, variable overhead \$5/unit and an allocated fixed overhead of \$35,000 (\$7/unit). The total cost per unit is \$26. XYZ company has offered to make and supply B1 to Beta Products for \$30/unit. If Beta accepts the offer then some of the facilities and production capacity used to make B1 could be used to help make another product B2 that would reduce the cost of making B2 by \$50,000 and also reduce the fixed overhead that would still have to be applied to B1 by \$15,000 from \$35,000 to \$20,000. By what amount would costs be increased or decreased if Beta accepts XYZ's offer?
- \$30,000 increase
  - \$5,000 increase
  - \$10,000 decrease**
  - \$30,000 decrease
14. Ultralight Co. manufactures torches. It can manufacture 300,000 torches a year at a variable cost of \$2.50/unit and a fixed cost of \$450,000. The forecast sales are 240,000 at a price of \$5 per torch. A special order of 60,000 torches will be sold at a 40% price discount of the \$5 regular price. By what amount will profit be increased or decreased as a result of the special order.
- \$60,000 decrease
  - \$30,000 increase**
  - \$36,000 increase
  - \$180,000 increase
15. The Big Bear Co. owns a chain of 45 small supermarkets. Budgeted data for the Lakeshore store is as follows: Annual sales \$425,000; Annual cost of goods sold and other operating expenses \$385,000. Annual building ownership fixed costs (not included previously) is \$20,000. The company can lease the building to a flower shop for \$4,000 a month. Should Big Bear:
- Close the store and sell the building
  - Close the** store and lease the building
  - Continue the store as it is
  - Minimize the store and rent a small section to the flower shop



## Marketing Accounting Metrics

# Chapter 4. Issues in marketing accounting

### Operating leverage

Firms that have high total fixed costs relative to total variable costs have high operating leverage. Companies that make planes, automobiles, computer chips and software have high total fixed costs compared to total variable costs: they have high operating leverage. Companies with low total fixed costs relative to total variable costs have low operating leverage. Examples of such companies are home builders, wholesale distributors and labor intensive industries. The higher the operating leverage, the faster a firm's profits will increase once sales exceed break-even volume ( $\text{Break-even volume} = \frac{\text{Total fixed costs}}{\text{Contribution margin per unit}}$ ). These are the high growth stocks that speculators love. But the reverse is also so. The losses of high leveraged companies are also greater if they do not make break-even. In other words, a high fixed cost structure is a potentially high return venture, but also runs a high risk of big losses as the following case-study explains.

Between 1998 and 2001, more than a dozen national optical fiber networks were constructed and a similar duplication occurred in Europe. New-entrant firms spent billions and the major incumbent telecoms followed suit. But at the very same time a remarkable new innovation in feeding and extracting signals from such networks increased transmission capacity 100-fold. As a result total capacity for carrying telephone and internet messages increased over 500 times, to meet demand that grew only four times over this period.<sup>1</sup> All the major telecom companies faced a disaster. Their fixed costs had increased enormously, far more than increased sales (demand). The investment might have paid off if demand had also increased hugely as a result of the dot.com boom, but it did not. The losses were huge because of the high fixed cost structure the investments created. The big winners were the new telephone calling-card companies that rented fiber network over-capacity very inexpensively on a variable cost basis; they paid a small variable cost for the calling capacity of the cards they sold. Thus, the over-investment in capacity not only created huge operating leverage that worked against the incumbents and new entrants that built optical fiber networks but it also created a swarm of new low price competitors renting network excess capacity at a very low cost.

Small start-up firms often have low operating leverage. This is because they have very limited investment resources so they have to outsource a lot of production, distribution and selling, which are almost all variable costs to the entrepreneur. They cannot afford to invest in the fixed costs that would enable them to do everything themselves. This means that when they grow, they do not get the increased profits from the fixed cost economies of scale. Instead, their outsourcer or alliance partner with the fixed cost structure get these leverage benefits. If a firm is sure to grow, it should try to raise the capital to enable it to invest in fixed costs and gain the resulting operating leverage. If its growth is uncertain, it should not risk the investment and outsource instead (see the Webvan case). Consider the following example.

A small start-up company is thinking about outsourcing its sales-force to a sales-rep company who charges 5% on each sale. The alternative is to continue to hire, train and manage its own sales-force. At present sales and costs the company accountant has said it seems a toss up as to whether outsourcing will cost more than an in-house sales-force. The company is expecting rapid growth: its sales may grow ten times in the next five years. How should this change its view of outsourcing the sales function and why? They should be against outsourcing because if the business grows tenfold, the cost of selling will also grow tenfold because selling costs are all variable, 5% of sales. But if they invest in their own sales-force, a sizable percentage of

<sup>1</sup> "Too many debts; too few calls." *The Economist*, July 20, 2002: 59-61.

sales-force costs will be variable and grow 10 times but another sizable percentage of the selling costs will be fixed and may not change much, as sales grow 10 times. At least far less than 10 times. This means the average cost per sale will decline because they are spreading these fixed costs across more sales. Total selling costs will grow but not by ten times, and the company will earn more profits from managing its own sales-force by taking advantage of its fixed cost operating leverage.

## Marketing cost mismanagement

Marketing costs include all costs incurred from the time the product is produced to the time the invoice is paid.<sup>2</sup> This includes all promotion, advertising, selling, distribution, collection and customer service costs. In practice, distribution costs are often the responsibility of another part of the organization and are not included as a marketing cost. Less than a third of companies include packaging costs, distribution costs, shipping costs and credit and collection costs as a marketing cost under the control of the marketing function. Apparently, customer service and physical distribution delivery service to customers are not perceived to be part of marketing in many companies. See the following Table 4.1.

**Table 4.1**

### **% of Companies that do Not Include Element in Marketing Costs<sup>3</sup>**

Advertising	4%
Sales promotion	5%
Catalogs, samples	5%
Marketing research	8%
Field sales force	10%
Technical services	45%
Inventory carrying costs	45%
Quality and customer service	58%
Physical distribution	73%
Shipping costs	74%
Credit and collections	86%
Packaging	87%

An extraordinary irony about this misallocation of cost responsibility is that over the last fifty year, the percentage of GDP (gross domestic product) in the U.S. spent on physical distribution costs has gone down from around 11-12% to around 7-8%.<sup>4</sup> It has been a remarkable increase in efficiency particularly compared to health care costs. But, in many firms, marketing has not been able to take any credit for this, even though distribution is a major market segmentation criteria, one of the elements of the marketing mix and, hence, a major element of marketing costs.

Overall, the problem for marketing systems control and marketing metrics is that some elements of the marketing mix are out of the direct control of the marketing function. Also, they are sometimes badly mismanaged by others, greatly increasing the probability that overall marketing costs will be mismanaged:

Given the reported practices of manufacturing companies that exclude significant elements of marketing costs, then it must follow that the degree of distortion in decision-making is even greater than Cooper and Kaplan suggest. Clearly, inventory carrying costs, quality and customer services, physical distribution, shipping costs, credit and collection expense, and depending on products and/or markets, packaging and technical services too are marketing

<sup>2</sup> Schiff, M. and Schiff, J.B., in C. Barth (ed.) *Marketing Cost Analysis for Performance Measurement and Decision Support*, *Institute of Management Accountants*, 1994, Montvale, NJ.,

<sup>3</sup> Financial Executive, "Marketing Costs: Back to Basics," *Financial Executive*, May/June, 1991, 35.

<sup>4</sup> Delaney, R.V., Is Logistics Productivity at a Crossroad? Simple Facts, Plain Arguments and Common sense, *Cass Information Systems*, 1994.

costs incurred to secure sales revenues. Excluding these costs can only magnify the distortion alluded to earlier. (Schiff and Schiff 1994, 8)

In the 1980s, the marketing function at packaged goods companies such as Procter & Gamble undertook many price promotions without accounting for the extra cost of distribution and inventory holding that price promotions created. This is because the cost of distribution was another department's responsibility so was not included in the cost and profitability analysis of those managing the price promotion campaigns. Because of the boom and bust in sales created by promotion pricing, much larger investments were needed in warehousing and inventory storage to cope with peak demand. In addition, the flow of the whole distribution system became less productive and more expensive.

When senior management finally became aware of this they very rapidly lost interest in price promotions. They went for stability and steady flow through the distribution channel rather than wildly swinging sales that required much larger capacity and, hence, investment in the distribution channel that is only occasionally used. They went for the Walmart relationship model of trying to add value to the relationship by greatly reducing distribution costs through greater cooperation, coordination, information sharing and logistics' innovation.

This problem of responsibility without control and decision distortion can be remedied by organizational restructuring. A simple solution is to give the Senior VP of Sales and Marketing, responsibility for all selling, promotion, customer service, marketing, delivery and after-sales service costs incurred from the time the product is produced to the time the invoice is paid. The senior marketing and sales executive then creates teams to manage all specific product-market segments and their costs. If senior management does not reorganize this way and change their accounting and reporting systems to consolidate all marketing costs, then they are not managing as well as they could. It is an example of how traditional practices can get in the way of more rational and better management of marketing processes.

### Often a wrong focus on sales

In 1994, a research project carried out on behalf of the *Institute of Management Accountants* studied the state of marketing cost analysis for performance measurement and decision support.<sup>5</sup> In a foreword to the research report, eminent management accounting scholar Charles T. Horngren of Stanford University observed:

Despite the advances in information technology and some recent calls for more accuracy in cost allocations, managers generally resist receiving too much detail. For years I have been struck by managers' innate desire for simplicity in their formal accounting systems. This phenomenon is probably an important reason why the call in the 1960's for vastly more sophisticated cost allocations in marketing did not enjoy widespread adoption.

This sounds like one explanation why activity-based costing has fallen out of favor. The report also concluded that in addition to the above stated desire for over-simplification, there was a misaligned incentives problem because incentives were paid to salespeople and marketers based on sales, sales growth and market share growth. As a result, "marketing cost analysis and its impact on decision making and performance evaluation fell into disuse." (Schiff and Schiff 1994, p. 27)

The following Table 4.2 suggests two trends. The first is that market share and sales are still up there as the most important marketing metric; but the second positive trend is that customer profitability (that implies the measurement of product and service profitability) is now a very common marketing metric for large U.S. and German firms.

<sup>5</sup> Schiff, M. and Schiff, J.B., in Claire Barth (Ed.), Marketing Cost Analysis for Performance Measurement and Decision Support, *Institute of Management Accountants*, 1994, Montvale, NJ.

**Table 4.2**  
**% of Large Firms Reporting Metric to Board of Directors<sup>6</sup>**

Metric	U.S.	Japan	Germany	U.K.	France
Market share and sales	73%	57%	97%	80%	90%
Service/product quality	77%	68%	84%	71%	75%
Customer profitability	73%	40%	74%	65%	59%
Customer life-time value	32%	35%	51%	32%	58%

What are we to conclude about all of this? The situation is getting better and the focus on sales in marketing is reducing. Moreover, the entrepreneur and competitor in all of us should recognize that there is a real competitive advantage for an organization to fix the over-simplification problem and the misaligned incentives problem, thereby gaining two competitive capabilities over its competition. This is just common sense.

Indeed, what can be the downside of fixing these problems that improve the cost and profit analysis capabilities of managers, and then provide them with the information and incentives to do such superior analysis? Isn't it the equivalent of giving them night-vision goggles? You can see the profit implications where others only see sales implications, and managers can be rewarded for increasing profits, rather than just increasing sales, often at the expense of profit.

It is also a common sense conclusion that a team's performance capability is improved if it is supported by an information system available to the team that generates reasonably accurate cost information, sales information, cash-flow generated and return on investment (see Chapter 2 on customer profitability information systems). It helps the team focus on the basic goal of all agent-run (i.e., professionally managed) organizations in a modern capitalist, free-market economy: to create shareholder capital (see Chapter 5.)

Marketing management is only as good as its measurement of marketing metrics and this has been a problem in the past because marketing performance has been measured in terms of its effect on sales and share rather than its effect on contribution, cash flow, profit and capital creation. Indeed, it continues to be a problem in many organizations, such as exemplified by the following decision bias:

“...Using a sales criterion to evaluate these elements of the marketing organization frees them of the responsibility for marketing costs incurred to serve them <customers> and leads to the view that services paid for by the supplier are “free” services. This view invites abuse of these services by the beneficiaries. The overall profit performance of the division or SBU obviously is affected, but management is at a loss to trace marketing costs to the customer, the channel of distribution, or the sales region or district without profitability measures for these segments.”<sup>7</sup>

<sup>6</sup> Source: Barwise, P. and Syler, A., “Which Marketing Metrics are Used and Where,” *Marketing Science Institute*, Report 03-111, 2003.

<sup>7</sup> Schiff and Schiff 1994, *op cit.* 23.

## Study Questions

1. The problem with managers is that they are too complex in their thinking about costs.  
a) True   b) **False**
  
2. The focus of marketing should be on sales and market share as the key marketing performance metrics.  
a) True   b) **False**
  
3. A study of what was included in marketing costs found that:
 

Advertising and sales promotion were included about half the time	True	<b>False</b>
Field sales force costs were included always	True	<b>False</b>
Inventory carrying costs were included about half the time	<b>True</b>	False
The cost of physical distribution was included 75% of the time	True	<b>False</b>
Packaging was included in marketing costs about 25% of the time	True	<b>False</b>
  
4. Marketing management is in a mess because of:
  - a) A lack of use of customer satisfaction metrics
  - b) A lack of use of customer loyalty metrics
  - c) A lack of consideration of all marketing costs**
  - d) None of the above
  
5. A way of impressing a recruiter is to ask if the company focuses on sales or product quality.  
a) True   b) **False**
  
6. A small start-up company is thinking about outsourcing its sales-force to a sales-rep company who charges 5% on each sale. The alternative is to continue to hire, train and manage its own sales-force. At present the company accountant has said it seems a toss up as to whether outsourcing will cost more than an in-house sales-force at current sales and costs. The company is expecting rapid growth where its sales may grow five times in the next five years. Should it outsource its sales force?  
a) Yes   b) **No**
  
7. If the company faces a much less optimistic future and is not sure whether it will survive the next two years should it outsource its sales force?  
a) **Yes**   b) No
  
8. Operating leverage comes from having high fixed costs.  
a) **Yes**   b) No

## Case 2: What Happened to the Grocery Delivery Service Webvan?

Launched in 1999, Webvan grew into the largest and seemingly most successful online grocery delivery service. It had 89% customer approval ratings, growing demand, and an operating margin ((sales – cost of sales)/sales) of 12%. This was far above the standard retail grocery margin of only four percent. But in July 2001, it filed for bankruptcy with accumulated losses of \$830 million!<sup>8</sup> What went wrong with this new business model? It was a problem of operating leverage. Webvan's fixed costs were very high because it invested in huge warehouses and marketing campaigns. Although its sales were solid and growing they did not approach the feasible volume needed to reach its targeted return on investment, even to reach break-even.

By comparison, another grocery delivery company, Peapod was started in 1989 in Evanston, Illinois by two brothers, one an ex-brand manager with Procter & Gamble and Kraft foods, the other a founder of a software company. From a small family business it grew into a public company (now fully owned by European grocery giant Royal Ahold) that has served more than 8 million customers. It offers 10,000 products but it learned to focus on high margin items such as farm-fresh produce, restaurant quality meats, deli trays, Kosher, organic and specialty foods. From the start it partnered with existing grocery retailers which meant that most of Peapod's costs were variable costs. It expanded into wealthy urban markets by working with existing traditional retailers again such as Safeway, Kroger, Giant, and Stop and Shop. In 1996, it created its Web site [www.peapod.com](http://www.peapod.com) and was named by Inc. magazine as one of the fastest growing U.S. private companies. Only after 10 years of operation in 1999 did it build its own dedicated warehouses.

WebVan is an example of the downside of operating leverage when a company tries to grow too big too fast, fueled by dot.com investor foolishness. Peapod is an example of a company that avoided the operating leverage problem by partnering with retailers and starting with very low fixed costs.<sup>9</sup>

### WebVan Study Questions

1. Peapod was a high leveraged start-up. When it started it had high fixed and investment costs.  
a) True **b) False**
2. As a result, keeping fixed cost and start-up costs low, this company was able to follow a Much less risky growth path. The company is:  
a) Webvan **b) Peapod** c) Both
3. If a Billboard for Peapod costs \$2,000 to create and \$2,000 per month rental, and a painted delivery vehicle is a quarter the size and impact of a billboard, how much does the company save painting their delivery vehicles (a paint job costs \$500) instead of using a Billboard?  
a) 2,000 a year per vehicle b) \$4,000 a year per vehicle **c) \$6,000 a year per vehicle**
4. It is fair to say that financial analysts failed to alert investors to this company's high-risk, high start-up cost structure? The company referred to is:  
**a) Webvan** b) Peapod c) Both

<sup>8</sup> Jackson, T., "Bold But Doomed Venture: Unsupportable Fixed Costs were Behind Webvan's Failure to Deliver the Goods," *Financial Times*, Tuesday, July 10, 2001, p. 17: Glasner, J., "Why Webvan Drove over a Cliff," *Wired News*, July 10, 2001.

<sup>9</sup> See Peapod company history at [www.Peapod.com](http://www.Peapod.com). Peapod had its own cash-flow problems before it settled on its current business model, which includes a significant catering business. Its problem was not recognizing that it was in a niche business and focusing on the most profitable product lines and customers with healthy margins.

5. There was a time when Webvan could easily have afforded to buy Peapod and adopt its cost structure.  
 a) Yes   b) No
6. Which company had an 89% approval rating with customers?  
a) Peapod    b) Webvan
7. In this company's model the supply of groceries was outsourced at a variable cost to retailers.  
The company was:  
 a) Peapod   b) Webvan
8. Which company's sales ceased to grow?  
a) Peapod   b) Webvan    c) Neither



# Marketing Accounting Metrics

## Chapter 5. Budgeting

“Budgeting is a common accounting tool that companies use for implementing strategy. Management uses budgets to communicate directions and goals throughout a company. Budgets turn managers’ perspectives forward and aid in planning and controlling the actions managers must undertake to satisfy their customers and succeed in the marketplace. Budgets provide measures of the financial results a company expects from its planned activities and help define objectives and timeliness against which progress can be measured.”<sup>1</sup>

Budgets are the primary tool used for planning and forecasting in an organization. “A budget is (a) the quantitative expression of a proposed plan of action by management for a specified period, and, (b) an aid to coordinate what needs to be done to implement that plan.”<sup>2</sup> A budget’s purpose is to set clear expectations about spending, costs, sales and all other financial transactions for the given time period the budget covers (monthly, quarterly, yearly, 5-yearly.) Sometimes budgeting is called *targeting* as at Hewlett-Packard or a *profit plan* at Owens Corning. When administered thoughtfully by managers, budgets do the following:

1. Promote coordination and communication among subunits within the company,
2. Provide a framework for judging performance and facilitating learning,
3. Motivate managers and other employees.<sup>3</sup>

When the expected (budgeted) performance of costs, sales and profits are compared with actual performance in a variance analysis (see *SI.Budget and Variance Analysis*), the variance between actual and budgeted expected performance can be evaluated, changes in processes made and future budgets and forecasts adjusted accordingly.

### The master and operational budget

The master budget has two components, an operational budget that reflects planned operating decisions/programs and a financial budget that reflects planned financial decisions of the company. The first operational budget is associated with the budgeted Profit and Loss Account. The second financial budget is associated with the enterprises’ Balance Sheet. In this tutorial we focus only on operational budgets. The Operating Budget for a service company consists of:

1. A forecast of expected sales provided by marketing based on expected success of marketing programs.
2. All costs accounted for and budgeted including:
  - a) A *Direct Labor* budget involved in delivering the services sold,
  - b) A *Direct Materials* budget accounting for all materials/products used in delivering the services sold.
  - c) A *Marketing Budget* for proposed marketing, sales and distribution strategy and its costs.
3. An Administration overhead budget,
4. A pro forma statement that provides investors financial projections about business development plans.

The operating budget for a manufacturer or distributor of a product is more complicated because starting and ending inventory has to be counted, its holding cost calculated and accounted for. The Operating Budget for a product manufacturing and distribution company consists of:

<sup>1</sup> Horngren, C.T., Datar, S.M. and Rajan, M.V., Cost Accounting: A Managerial Emphasis, 14<sup>th</sup> ed. Boston, *Prentice Hall*, 2012, 182.

<sup>2</sup> Horngren *ibid*.

<sup>3</sup> Horngren et al. 2012, 185.



1. A forecast of expected sales provided by marketing based on expected success of marketing programs.
2. All costs accounted for and budgeted including:
  - a) A *Direct Labor* budget involved in delivering the products sold,
  - b) A *Direct Materials* budget accounting for all materials/products used in delivering the services sold.
  - c) A *Marketing Budget* for proposed marketing, sales and distribution strategy and its costs.
  - d) An *Inventory Holding* budget
3. An Administration overhead budget,
4. A pro forma statement that provides financial projections about business development plans to external parties (usually to raise funds).
5. An Administration overhead budget,
6. A pro forma statement that provides investors financial projections about business development plans.

### Human aspects of budgeting

All types of budgeting benefit when lower-level management participate in a bottom-up budget approach. This increases middle management commitment and accountability<sup>4</sup>. The Percy study found that 60% of marketing budgeting uses a bottom-up/top-down process, 26% a top-down/bottom-up directive procedure (often the result of financial stringency and severe budget constraints) and seven percent a simple bottom-up procedure. The bottom-up/top-down dominant procedure was most profitable. But this bottom-up proposed and top-down approved process requires honest target setting by lower management and not *budgetary slack* which is when lower management underestimate revenues and overestimate costs so as to make budgeted targets easier for them to achieve.<sup>5</sup> This particularly occurs when a performance-compared-to-budget metric is used to evaluate manager performance. In organizations where managers are promoted from within, senior managers will be more likely to detect slack in the budgets of their subordinates whose job they have had. Another remedy is to do what IBM does. Division managers are rewarded, the higher and more accurate are their budgeted profit forecasts.

An exciting new type of budgeting is ***Kaizen Budgeting***. It incorporates continuous improvement in cost reduction mostly from small improvements suggested by employees. Companies that create a culture that encourage employee cost reduction suggestions such as GE and Toyota do not use standard costing but rather expect budgets to reflect Kaizen cost improvements rather than long lasting cost standards.

### Traditional marketing budgeting methods

According to the *Conference Board* study results presented in Table 5.1 below the most commonly used marketing budgeting method is to base the budget on what was spent the previous year. The advantage of basing the budget on what was spent in the past (**historic budgeting**) is that it does not require a lot of justification to senior executives. A dramatic increase or decrease from past spending would require a rational explanation why; particularly a big increase as it is likely to mean that some of the increased spending will have to be taken from another company budget. The manager or team that the extra spending is coming from will very likely object, challenge the change and ask for a rational justification which they then attack. The result is that expensive line items in prior marketing budgets such as national TV and magazine advertising are slow to change. This same spending from year to year on the same item, discourages new ideas and initiatives such as switching most spending to Internet search advertising whose effect might be greater and also measurable.

<sup>4</sup> Percy, N.F., "The Marketing Budgeting Process: Marketing Management Implications," *Journal of Marketing*, 51(October), 1987, 45-59. The *2000 Conference Board Study* in Table 5.1 reports that 50% of surveyed companies use a top-down directive approach compared to 26% in the 1987 Percy study.

<sup>5</sup> Horngren et al. 2012, 202.



And what was the rationale for last year's spending? If it was based on the previous year, and the previous year's spending on its previous year etc. and no real explanation can be given for past spending except that it was based on even earlier spending, then this is not procedurally rational. It may be safe for the managers and by definition conservative but it is quite irrational.

Basing marketing spending on last year's spending also defies one of the fundamental principles and purposes of marketing: marketing is meant to change customer preferences and to change company thinking, products and processes. If marketing is worth spending on, then it should *change* the market and company performance. As a result using the past as a basis for a changed presence makes no sense. In very dynamic markets that are rapidly growing, with a lot of new competition investing in brand recognition in the market, basing spending on past budgets can lead to a greatly reduced share of voice (share of marketing spending in the market) and, as a result, a reduced market share. When industries, technologies and companies go through product development cycles then marketing spending should be very high during high growth of sales in the category, and much lower when markets are in an innovation stasis (not innovating in products and services).

Furthermore, the historic budgeting approach may be the most commonly used budgeting method for existing firms but how do you budget when you have no history, if you are starting up a new business development venture?

**Table 5.1**  
**Budgeting Methods Used by Large Companies\***

"Is your marketing budgeting/spending based on any of the following?"  
(Please check all that apply).

	% using
Last year's sales and spending.....	64%
General budget directive (e.g., reduce all budgets by 10%) .....	50%
Specific top-down numbers.....	42%
Opportunities and threats revealed by marketing plan.....	41%
Percentage of expected sales.....	40%
Apparent potential of initiatives proposed in the plan.....	39%
Competitive situation.....	37%
Ability of those responsible to sell their proposed budget.....	33%
Bang-for-the-buck marginal return analysis.....	29%
Past performance of those responsible.....	23%
Activity based costing.....	22%
Political clout of those responsible.....	20%
Traditional overhead allocation costing.....	19%
Budget dollars are re-allocated based on unexpected success or failure .....	18%
ROI computer model.....	16%
What-if spreadsheet analysis.....	14%
Matching major competitor's expected spending.....	7%
Computer optimal marketing mix spending model.....	2%

\* 2000 Conference Board Marketing Plan Study, n = 200 companies

*What was spent last year is the most common basis for a marketing budget, followed by top-down directives and even top-down specific numbers (the latter presumably eliminates any other basis for setting budgets!). More defensible techniques such as marginal return analysis, what-if spreadsheet analysis, activity-based costing, re-allocation based on unexpected performance, and analytic modeling are far less frequently used. And this study overstates the incidence of these procedurally rational budget practices because many of the respondents were Fortune 1000 companies with more advanced analysis skills*



A budget that is based on industry **percentage of sales** spent on marketing is an “in the ball-park” starting-point budgeting method. If the industry spends 20% on marketing and sales then company spending according to this method should be 20% of expected sales of the firm. But this method also has some serious problems. The method ludicrously puts the cart before the horse. Marketing spending is meant to increase profitability, through increased dollar sales of more profitable products and services to more profitable customers. If a new product is being launched that is superior to the competition then the more money that is spent on the marketing campaign, the greater will be the sales. The fundamental point and principle involved is that marketing *drives* \$ sales, rather than \$ sales *drives* marketing. Thus, when an entrepreneur or executive asks what percentage of expected sales should be spent on marketing, he or she is confusing cause and effect.

Looking at the percentage of sales spent on marketing across an industry (often called the advertising/sales ratio: A/S for short) is still, at least, a basis to start from in marketing budgeting. Some economists might even argue that if the market is efficient that the A/S ratio the market has settled on is close to optimal. But a little more thought also exposes this method’s flawed procedural rationality. Why should you believe that the industry has it right? Canon shook up the single-lens reflex camera market in the 1980’s by greatly increasing its marketing spending above the industry A/S average. From being a second tier competitor it rose to dominate the market and the increased advertising of this type of camera greatly increased its market size.

If percentage of sales also becomes the standard budgeting method across an industry with a very large established competitor, the absolute \$ spending by this competitor on marketing will swamp a small rival’s effect of spending based on the same percentage of sales ratio. If marketing spending is effective, this will mean that the large rival will continue to gain sales and share from smaller rivals and the market will be even more monopolized by the big supplier. .

This brings us to a method that attempts to avoid the-bigger-get-bigger outcome by arguing that you should try to match your rival’s spending. Called the **competitive parity** method according to the above study, it is very infrequently used, perhaps so infrequently used as to question the value of explaining its logic. The logic of the competitive parity method is that if you are a new entry into a market, such as Hyundai into the North American car market, then you need to match the marketing spending and efforts of established rivals such as Honda, Toyota, Ford and GM. The result is that a new entry may spend in its first years in a market even more than it earns in sales, over 100% as a percentage of sales, while established rivals such as GM spend 10% of sales on marketing and advertising.

But what if you have a really winning product that is much better quality or value for price than your rivals? Do you match their sales when you know that the return you will get for the dollars spent on marketing will be much greater than the return they will get from their spending? Your return will be greater over the longer term as consumers buy your product, experience the superior quality, become brand loyal and pass the word on. This increased satisfaction builds brand reputation and future repeat sales and referral sales as explained in Chapter 2.

In short, you should increase the budget for marketing and advertising when you have something to shout about. Your spending on advertising and marketing should be much less when you have nothing much to say. More correctly, in the latter case you should spend more on research and development and creating a new, improved, very competitive product or service that you will truly have something to shout about. Thus, the marketing budget’s size should depend on the opportunities and threats that you face that determine your goals and strategy.

**Objective-task budgeting** first sets an objective such as increasing sales by 10%, increasing product awareness by 20%, or gaining a thousand new customers. Then the judgments of experienced marketers or the advertising agency is used to propose the amount that needs to be spent on the campaign to achieve this goal. This judgment may be based on the success and cost of past campaigns. But if you do this you are looking in the rear view mirror again to make your decision. The objective-task method also has other problems. The objective is a short-term goal. If the objective goal is longer term, an additional guesstimate is required as to what effect increasing sales



or product awareness in the short-term will have on future sales, and most importantly on future profits, because as we have already learned, the goal of marketing and marketing spending is to increase profits and not sales.

The objective-task method is also limited if it does not consider the fundamental marginal-budgeting principle that has been recommended by marketing experts.<sup>6</sup> The principle is that dollars should be allocated to spending on marketing to customer segments, to spending on products, to particular components of the marketing mix, and to specific marketing programs that create the most shareholder wealth. Furthermore, it should be based on the return expected on spending the last or marginal dollars. The way to think about this is to ask, so if I had an additional \$10,000 or \$100,000 to spend on marketing where would such spending create the most capital (shareholder wealth)? Would it be best to spend it on increasing the consumer advertising budget? What about spending it on trade relations or on a publicity campaign? Would it be better to spend it on improving customer service, or invest it in better sales training or on improving the packaging; or how about spending it on new product development?

What this describes is a **marginal budgeting** process that makes economic sense and practical sense (see spreadsheet *S6. Marketing Mix Analysis (Marginal Budgeting and Shareholder Value Analysis)*). First, the criterion is shareholder wealth (capital creation) in the short-term *and* the longer-term. Second, it takes into account the likely effect of spending on specific components of the marketing budget and not just the whole marketing budget. This means that the decision can be built on the expertise of those involved in each of the elements of the marketing mix. Third, the question that is answered is not just how much to spend overall on advertising or marketing, but *where* should the next \$10,000 or \$100,000 be spent? Both the marginal return and objective-task methods require the same sort of expert judgment. The objective-task method sets a goal and then requires a judgment as to what it will cost to achieve the goal. The marginal return method specifies a dollar amount that you are considering spending (i.e., the cost) and requires a judgment as to what the return to shareholders will be.

There is an additional practical advantage of the marginal return approach. Often, proposed marketing budgets are sent up to senior management who then cut them because the company cannot afford the proposed budget (the **affordability budgeting method**). The message comes back: cut the budget by 10%, often with no justification except that what was proposed is too much. If the marginal, last dollar spending approach to build the budget is used then the same approach can be used to cut the budget. Cutting all components of the marketing budget by 10% across-the-board assumes that spending across all components of the marketing mix is equally effective in increasing future profitability (a false assumption). Using marginal budgeting, the spending on a particular component of the marketing mix that has been estimated to be least effective can be cut first – then the next least effective, etc. - this is the rational response.

What emerges from the above analysis is the following recommended budgeting process that combines the strengths of several of the above methods. It is an adaption of an *American Advertising Agency Association* recommended budgeting process for advertising spending.<sup>7</sup>

## Recommended marketing and sales budgeting method steps

1. **Situation analysis:** Including economic forecast; product life-cycle stage – SWOT analysis, focus on profit and ROI opportunities and threats, planned launch campaigns,

<sup>6</sup> Lodish, L.M. Advertising and Promotion: Vaguely Right or Precisely Wrong? *Oxford University Press*, New York, 1986 and Rossiter, J.R. and Percy, L., Advertising and Promotion Management, *McGraw-Hill*, New York, 1987.

<sup>7</sup> Farris, P.W., Shames, E.R. & Reibstein, D.J. Advertising Budgeting a Report from the Field. New York, NY, *American Association of Advertising Agencies*, 1998, 28-29. These authors' process was based on Low, G. and Mohr, J.J. Marketing Communications Budget Allocations: Antecedents and Outcomes, Cambridge, MA: *Marketing Science Institute*, 1997.



- business unit objectives for sales, market share and profitability. Top-down spending directives and constraints.
2. **Ball-park budgeting:** use % of sales of industry or major rivals. Recognize last year's budget is a starting point as well. Analyze bottom-line effects of different marketing spending using spreadsheets and various what-if assumptions. What sales and market share will be needed to meet profit and shareholder value creation goals?
  3. **Budget fine-tuning:** make adjustments to item budget spending based on estimated response to incremental changes in spending across the marketing mix. If possible use analytic modeling (but this is rare): if not, use a version of the incremental budgeting approach presented in the *S6. Marketing Mix Analysis (Marginal Budgeting and Shareholder Value Analysis)* worksheet.
  4. **Budget setting: approval by senior management:** Present budget and process used to create it. Have top down directives been followed?
  5. **Implementation and Improvisation:** Re-allocate spending across the marketing mix budget items based on performance compared to expectations – at least for cases of extreme under-performance and over-performance. Appeal budget if competitive situation and opportunities/threats change significantly (go back to 1. above)

The process is procedurally sound in that it is situation and opportunity based, starts with a ball-park estimate and is refined through marginal budgeting that sets the amount of budget and its allocation based on increasing shareholder value (see next section). Finally, the budget is modified based on actual early performance. All of this logic is however bypassed if senior management set the budget and it cannot be appealed. According to the above **Conference Board** study the marketing budgets in as many as 40-50% of large companies are set this way by senior management. In smaller companies the percentage is probably even higher.

## Value based planning and budgeting

The leading marketing management thinker of the last several decades, Professor George Day, explained in an award winning paper why marketing should use discounted cash-flow and present-value analysis in the search for shareholder value.<sup>8</sup> He called it value-based planning. "Marketers can now expect that proposals for promotional campaigns, price changes, sales-force increases, and product-line additions and deletions will increasingly be subjected to this new <present-value> performance yardstick." (p 46): "The value-based planning framework offers a possible cure for all the handicaps that marketers bring to the negotiation for resources." (p.56)

How does shareholder value change? Here is how. As an example, financial analysts on Wall Street set an expectation of a risk-adjusted return on capital of 20% before taxes for a specific company in an industry. This sets the market expert's target trading range for the company's stock. If it trades lower than this set range, the analysts recommend buying, the company share price goes up and shareholder value goes up (capital is created). If the return on capital turns out to be less than 20%, the analysts recommend selling and share price goes down and shareholder value goes down (capital is destroyed.) If return on capital is higher than 20%, share price goes up and shareholder value goes up. This is the capitalist market's way of setting the value of shares because the current value of shares multiplied by the number of shares issued is total shareholder value, wealth and capital.

The primary goal of all managers, as paid agents of shareholders (owners), is to increase shareholder capital. In our simple example, company resources should be deployed (budgeted) such that their resulting revenue streams earn a rate-of-return greater than 20%. If a marketing mix strategy generates a return of more than 20%, then the strategy will create shareholder value because it is earning more than a 20% return for shareholders. You will see this demonstrated in the *S6. Marketing Mix Analysis (Marginal Budgeting and Shareholder Value Analysis)* tutorial. At a 20% shareholder- required rate of return, the net present value of the strategy, project or element of the marketing mix is the shareholder value created. It is that simple.

<sup>8</sup> Day, G. G. and Fahey, L. "Valuing Market Strategies," *Journal of Marketing*, 52, July, 1998, 45-57.



Thus, the one metric that all managers in charge of the marketing mix and marketing spending must try to estimate beforehand and afterwards is net present value (NPV). This enables managers to think about the amount of shareholder value that the budget, investment or project is expected to create, and actually does create.

Survey research studies showed use of NPV and discounted cash-flow analysis in budgeting amongst large firms to be 19% in 1959, 38% in 1964, 57% in 1970, 86% in 1978.<sup>9</sup> But even the largest and most sophisticated companies use NPV piece-meal. It is used in budgeting but few companies use it to audit and evaluate major investments and when they do, it seldom leads to a termination or abandonment of negative NPV investments.<sup>10</sup> Perhaps the reason why NPV is not used more is that when undertaken, the results are not understood and/or used by senior management and boards of directors, so why bother?

It suggests an opportunity for rivals, who hire managers and board members with the skills to use NPV and make NPV thinking part of the company culture. Listen to another important thought leader in management accounting, Professor John Shank talking about AT&T's purchase of McCaw Cellular: "The reader may be skeptical that real managers in real businesses could be so oblivious to the basic multiyear NPV economics of the business they are operating ... In 1994, work I did for McCaw Cellular (the largest cell phone company in the USA, which was acquired by AT&T in 1995 for \$20 billion) indicated pretty clearly that the lifetime NPV of McCaw's average customer was negative. I doubt AT&T had done this analysis."<sup>11</sup>

Such a devastating conclusion is hard to comprehend and believe. It suggests that the market opportunity and investment analysis of large companies, at least AT&T, does not apply management accounting best practice, even when it comes to \$20 billion decisions. It also suggests that you can help some, perhaps many, companies do a lot better in their marketing budgeting by applying what you have learned above, and what you learn in the following spreadsheet tutorials/case studies.

## Postscript

If you wish to learn more about numerous types of other intermediary marketing metrics that can be used to measure and diagnose performance then you should read the (digital) book, **Marketing Metrics: The Definitive Guide to Measuring Marketing Performance** written by Paul W. Farris et al. 2010, *Pearson Education*. It is as its title says, the definitive guide to marketing metrics. It is your bible if you are seeking to improve process performance in marketing and want to measure the right metrics. But it is more than a lot of definitions and examples. It gives very sensible advice on how to measure and use the metrics. It also details the survey of senior executives presented in Chapter 1 above. It can also be acquired on Amazon.com very inexpensively.

For a shorter, further read the following is recommended: **Marketing Metrics and Financial Performance**, written by Don Lehmann and David Reibstein, Cambridge, Mass, *Marketing Science Institute*, 2006.

<sup>9</sup> Susan F. Haka, "A Review of the Literature on Capital Budgeting and Investment Appraisal: Past, Present, and Future Musings," in C.S. Chapman, A. G. Hopwood and M. D. Shields (eds.), *Handbook of Management Accounting Research*, Vol. 2, *Elsevier*, Amsterdam, 2007, 697-728.

<sup>10</sup> Haka, *ibid*, 2007, 723.

<sup>11</sup> Shank, J.K., "Strategic Cost Management: Upsizing, Downsizing and Right (?) Sizing," in A. Bhimani (ed.) *Contemporary Issues in Management Accounting*, *Oxford University Press*, 2006, 378.



## Study Questions

1. A budget is:
  - a) The quantitative expression of a proposed plan of action by management for a specified period
  - b) An aid to coordinate what needs to be done to implement that plan
  - c) **Both a** quantitative expression of a plan of action and an aid to coordinating what needs to be done
  - d) None of these
2. The Master Budget consists of:
  - a) An operating, financial and capital budget
  - b) An operating, financial and cash flow budget
  - c) A financial and cash flow budget
  - d) **An operating and financial budget**
3. The Marketing Budget is classified as:
  - e) A capital budget
  - f) An operating budget**
  - g) A master budget
  - h) A financial budget
4. Which of the following is not part of the budgeting process:
  - a) Accounting for all costs
  - b) A pro formula** statement
  - c) Forecast sales based on proposed strategy
  - d) An administrative overhead budget
  - e) They are all part of the budgeting process
5. If a cost is small and can be allocated to marketing:
  - a) You may include or exclude it from the Marketing Budget
  - b) Include it in the Marketing Budget**
  - c) Include it but not allocate it in Marketing Budget
  - d) None of the above
6. In the Conference Board Study, the most common basis for setting a marketing budget is?
  - a) Matching competitors' expected spending
  - b) General budget directive
  - c) Apparent potential of initiatives proposed in the plan
  - d) Last year's sales and spending**
  - e) Bang for the buck marginal return analysis
7. What percentage of companies in the Conference Board study use "Bang for the buck" marginal return analysis in their marketing budgeting?
  - a) About 20%
  - b) About 30%**
  - c) About 40%
  - d) About 50%
  - e) About 60%
8. Which of the following budget methods requires the least justification?
  - a) Historic method**
  - b) Percentage of expected sales
  - c) Competitive parity
  - d) Objective-task
  - e) Marginal return



9. Which of the following statements is least true about the historic method of budgeting?
- It is irrational
  - It defies a fundamental principle of marketing
  - It is politically acceptable
  - It is a reasonable starting point**
  - It discourages new ideas and initiatives
10. The industry average spending on advertising is 5% of sales. Your major competitor spends \$12 million a year on advertising. Your boss says he wants an advertising campaign that will raise your retention rate of current customers from 50% to 75%. Your advertising agency says that this require an advertising campaign that will cost \$10 million, about 6% of your expected sales. You agree and propose such an advertising budget. You have used what budgeting method?
- Percentage of sales
  - Competitive parity
  - Objective-task**
  - Percentage of sales and objective-task
  - Percentage of sales, competitive parity and objective-task
11. Which of the following is not true?
- Canon taught the camera market that it was spending too little on advertising.
  - You never spend more than 100% of sales on marketing.**
  - The objective-task method and marginal return method use similar guestimates.
  - The percentage of sales method puts the cart before the horse.
  - Affordability is a top-down budgeting method.
12. Value-based planning is about increasing:
- Product value
  - Product and service value
  - Customer value
  - Shareholder value**
  - Customer and shareholder value
13. The role of managers, as economic agents, is to:
- Make sound economic decisions
  - Serve the interests of the customer
  - Serve the interests of all interest groups
  - Serve the interests of the owners**
  - Look after their own interests and hence the interests of the owners
14. Which of the following is not true?
- Professor Day thinks value-based planning increases a manager's negotiating position with senior management.
  - Managers who do not think in terms of shareholder value can make decisions that generate lower shareholder value.
  - Shareholder value is the same as capital.
  - NPV is the queen of all marketing metrics.
  - AT&T's acquisition of McCaw Cellular is an example of excellent shareholder value analysis.**
15. Thinking about shareholder value is done using the net \_\_\_\_ value framework?
- Future
  - Present**
  - Potential
  - Economic
  - Customer

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