How to Establish Useful Customer Profitability Reporting

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Summary: In conditions of market economy the issue of adaptation of the Bulgarian accounting theory and practice to the European and global tendencies has emerged. Financial information should assist managers in the decision making process. In this regard, the purpose of accounting is expressed not only in the activities of book-keeping of past business events, but also in providing information to support strategic and operational decisions and to control their implementation. For that purpose, it is necessary to achieve a single methodology for creating and using of accounting information (specific database and bank internal managerial reporting) for correct interpretation of customer relationships.

The objective of this paper is to clarify from a theoretical and methodological viewpoint and to encourage the practical implementation of the analysis of customer segments based on provision of relevant accounting information, customized to the specific conditions in Bulgarian commercial banks.

Key words: commercial banks, customer relationships, management accounting, funds transfer price, customer profitability reporting.

JEL: M41, G21.

Quick advancement of the banking sector made it necessary to rethink the role of accounting as an evolving system. This research paper was induced by the pursuit of a more in-depth theoretical and methodological clarification and a wider practical implementation of the analysis of customer segments based on information provided by the accounting.

Adequate management of the bank requires executives to know the financial standing of the institution, to plan and control the operational processes and to take managerial decisions on customer relationships. Clients visit the bank with the expectation of a high level of service. A major challenge for banks is to provide such a level of service that still allows improving of profitability and increasing of market share. Today the cost to consumers to switch the bank is low and the varied range of attractive products is no longer sufficient to ensure the loyalty of customers. Alteration of marketing practices stays among the many changes in the financial services industry in recent years: from a transaction-oriented approach (focus on bank products) to a customer relationship oriented approach (focus on customer). It is believed that customer satisfaction is directly related to multiple uses of a service, as well as with advocating the service to other subjects.

In some banks no system for reporting at the customer level exists. In other organizations it is available, but the process is not automated. In third group of banks, this is part of a system that is used regularly. The today's tendency in financial institutions is to have some form of reporting, notwithstanding that it might be insufficiently developed.

In banks that have no reliable system of customers' analysis based on accounting data bank employees are usually appointed, who subjectively concentrate on their activity. The officer keeps an eye on the revenue, balances and activity, except customer profitability data. Following this strategy, the bank staff should sell and administer everything offered by the bank, and leave the managers of higher levels in the organization to care about the profitability. The main motive is to boost sales, and to become aware that fee revenues and interest income are generated. The costs are out of consideration at the level of bank officer appointed to serve the customer.

We believe that bank employee should be held responsible for customer's profitability; therefore, he/she must have access to the most detailed customer information with the aim to improve the relations. New opportunities to sell are result from the diversity of products that the bank offers to a particular client, and from the client profile assessment in determining the market needs.

Since banks constantly diversify their business, it is necessary to have a clear vision of the opportunities for selling of additional products (cross-selling) and to become aware of the unfavourable relationships.

Customer relationship management is directed to maintain profitability at client level. It includes reviewing and taking actions with regard to the used services, existing balances, fees collected for services and a cost data system at customer level. In this connection it is recommended to agree in advance the extent of direct costs allocation. In some systems unit costs are determined on a full absorption basis. This means that general and administrative expenses of the bank are included. The complexity of the system depends on the bank size, the number of its clients and the number of products. To meet the future challenges, banks need an adequate customer database, which should store the following:

- fees and commissions at client level;
- account balances at client level;
- customer's activity;
- customer product profile;
- income at client level.

Reliability of the system requires a logical approach to encompassing and reporting of data. All components must represent the same reporting timeframe. If cost data are static, they should be updated annually or in agreed periods of time. Systems that track and store cost data in real time are complex and usually very expensive.

Our goal is to embrace the essence of customer profitability reporting and the approaches for establishing a system that provides information to improve management of the customers and the sales. The aim is to cover all relationships with the client: liability-type transactions related to attraction of funds in different forms; asset-type transactions; agent-type transactions; custody services; which actually means cross-analysis by customers and by products. Individual banking transactions very rarely exist independently. In most cases, there are connections and relationships among them: for example loan granting is related to cash and noncash payments. As the assessment is carried out based on all movements on the client accounts and by types of transactions, handling of this information is the most labour-consuming one. The accuracy of the calculations requires a very large capacity of computer systems. When analyzing the results by customers they can be combined in: large groups (correspondent banks, individuals, corporate customers, key customers); categories in the large groups – industry sectors and branches; geographic locations (country, economic regions, etc.) as well as presented as individual clients. The determination of results by customers is performed through comparison of revenue (e.g. in the form of fees and commissions) and costs incurred (e.g. accrued and paid interests, costs of accounts' handling).

Creation of client groups requires both to know the relationships in the existing customer database and to assess the availability of appropriate data to allow proper combination. A review of client data in the already existing customer register is a reasonable step before implementing a profitability system that would ensure the data quality.

Classification of the types of bank customers typically includes the following groups:

- Domestic and foreign customers;
- Corporate customers – large and medium enterprises;
- Small enterprises;
- Correspondent banks;
- Individuals and households (retail banking);
- Budget institutions.

Based on this brief classification, the clients being enterprises can be grouped further according to the business activity, for instance using the official categorization of the economic activities of the National Statistical Institute. This would allow segmentation by economic sectors, subsectors, groups and classes. It is also possible market segmentation as per the geographical location. All issues of this kind could be solved through appropriate system of analytical accounts to aggregate data about the customer relationship (income, expenses, activity, balances, revenue) and the market segmentation by size and by its physical positioning – as a tool for decision making.

Profile of services' utilization by clients will provide to the bank the needed information to coordinate the sales. Separate customers are known personally in smaller bank branches and there is no essential need for information system. However, the number and the complexity of the relationships increase as a result of the enlargement of the branch, as well as of the bank as a whole. When this is combined with the fact that banks have traditionally measured the turnover in its customer base once per year, the need emerges for systematic tracking of the clients. Customer turnover is costly in terms of omitted future income, but also because of increased costs to close the relationship. The reasons for turnover are different: some customers leave because they move from the local community. But banks avoid losing customers because of dissatisfaction with banking services, whereas customers typically expect anyone in their bank to know everything about their relationship and their specialized needs, and to understand their personal finances.

For example, a client may wish to purchase a credit card and mentions he/she would like to be exempt from certain fees and commissions. Bank staff should be able to become aware that customer relationship is sufficiently profitable to compensate the non-payment of fees and commissions on the credit card. It is necessary that the employee can look at the client's report on a computer screen and decide. At a higher level, the management should be able to generate reports about customer segments. This is particularly important during campaigns for the sale of certain products and can be a valuable marketing tool.

We believe the reports at client level should contain the following information:

- Collection of static data for the customers in current year's portfolio:
    - Customer number;
    - Customer name – name of a individual or a company;
    - EGN/Bulstat;
    - Current customer's segment;
    - Contact address;
    - Telephone number;
    - Additional customer's data – for instance, number of family members, family income, property, credit history, age, sex, profession.
- Historical Information.

Information about the previous relationships with the bank customer may be useful in deciding on the new credits' granting or exemption from commissions. It may include: opening date of account, account number, account type, average balance, closing date, recorded repayments of loans.

- Date, on which the client has begun the relationship with the bank – important to determine stability.
- A list containing data at customer level with a reviewing option to selecting a specific bank account and sorting by different criteria: this provides information about the client accounts currently existing in the bank.
- Number and volume of transactions on open accounts
    - Deposit accounts: opening date of account, account number, product description, current balance, average balance for a period; alerters about exceeded limits or blocking;
    - Loans: date of granting of each credit, account number, description of the loan type, current debt, recorded late payments;
    - Credit lines/ credit cards: date of opening/ issuing, account number, type of credit line/ credit card, current debt, recorded late payments or bank card lost.
- Creditworthiness rating.
- Services used.

Services that the customer has used over the past 12 months. This is information that reveals the profile of the customer's needs for banking services and is just as important as the data on deposits, loans and credit lines/ cards. Each service is listed by date of use, product name, commissions paid, the exemption or reduction of certain fees and volumes.

- Appointed bank employee to service the customer.

Calculation and monitoring of the following specific elements is proposed in setting up the system with client data:

- ***Funds transfer price:*** the rate applied by the bank as regards a transfer fund used for internal distribution of financial resource; components of the funds transfer price are:
    - Interest rate risk percentage;
    - Liquidity premium

Factors influencing the funds transfer price are: the type of currency, financial instrument maturities and client risk.

$$\text{Funds transfer price} = \\ = \text{Interest rate risk part} + \text{Liquidity premium} \quad (1)$$

- ***Net interest income (NII):*** computed on the basis of the funds transfer price; NII for credits is calculated by reducing the interest income received on the loan plus the deferred part of the loan administration fee with the funds transfer price for the resource needed to grant the loan, as well as with the deferred bonuses offered by the bank; NII for deposits is the difference between the funds transfer price obtained for the use of attracted funds, and the interest expense paid to customer increased by 0.5 % contribution to the Deposit Insurance Fund.

• ***Unit price of the products used:*** determined as a result of the cost analysis.

• ***Expenses for services and products provided:*** they are result from the standard

Table 1. Model of customer level report – individuals

CUSTOMER LEVEL REPORT - Individuals

Reporting level:
As of date:

Customer data						
Customer Name	Unique Id	Segment	Responsible Bank Employee	Branch	Economic sector	Net Income

Indicators	Current period	Budget	Budget variation	Prior period	Change
Net Turnover					
Average Loan Exposure					
Net Interest Income from Loans					
Interest Margin on Loans (%)					
Consumer Loans					
Monthly average balance					
Net interest income					
Spread (%)					
Credit Cards					
Monthly average balance					
Net interest income					
Spread (%)					
Mortgage Loans					
Monthly average balance					
Net interest income					
Spread (%)					
Overdrafts					
Monthly average balance					
Net interest income					
Spread (%)					
Nonperforming Loans					
Monthly average balance					
Net interest income					
Spread (%)					
Monthly Average Balance of Funds Received					
Net Interest Income from Funds Received					
Interest Margin on Funds Received (%)					
Current Accounts					
Monthly average balance					
Net interest income					
Spread (%)					
Term Deposits					
Monthly average balance					
Net interest income					
Spread (%)					
Savings Accounts					
Monthly average balance					
Net interest income					
Spread (%)					
Net Interest Income - Other					
Net Fees & Commissions					
Loans and overdrafts					
Bank guarantees					
Current accounts					
Debit and credit cards					
POS transactions					
Investment funds					
Payment transactions					
Letters of credits					
Securities and custody					
Other fees and commissions					
Net Income from Foreign Exchange Gains					
Indirect costs to service the customer					
Provisions to cover risk exposure impairments					
Net Income					

price and products volume. It is necessary because of the potential for price discounts.

In summary, to obtain a complete and accurate picture of the results, the customer analysis based on accounting data requires information at the level of customer account, including deposits, loans, bank cards, funds on custody and all other products or services purchased by the customers. The complex systems distinguish and record the volumes of transactions executed and the cost of each of them, for instance number of open bank accounts, number of issued cheques and others. It is also necessary to consider the risk level associated with specific client to determine the impairment costs on risk exposures. The review of the cost of funds and maturity structure are used in funds transfer pricing. Elements to calculate the profitability of separate customers or customer groups are: daily average balance, bad debts, net interest margin (including adjustment for interest rate risk); provisions on risk exposures, non-interest income and allocated operating expenses. The integrity of data in each subsystem is critical to obtain a precise result for the profit. Based on these data reports can be developed to be used within the bank. Model of a report to analyze individuals at client level is proposed in Table 1.

Through appropriate algorithms, data for individual customers are processed by different geographic and demographic groups for the purpose of marketing analysis. In such a way recap information is obtained for each customer segment or selected geographic area. The ultimate goal is to improve customer relationships in addition to providing further opportunities for selling and bigger profits.

Information on the achieved results facilitates: taking of tactical decisions about pricing; the utilization of opportunities for cost reduction; increasing profitability of customers that currently bring low revenue; the identification of products to be advertised and sold and what distribution channels to be used. Based on the analysis, the managers reach better strategic decisions – about new product introduction or getting of existing products to the best positions, by determining the customers on which marketing efforts should be focused.

We express our expectation that the findings, conclusions and prepared proposals will provoke the thinking of professionals in the field of accounting and will be useful for the managing bodies of the banks, in their strive to increase the effectiveness of customer relationships.

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