Financial Reporting Should Include Customer Equity

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Investors are the "consumers" of financial reports. They digest the information at hand - balance sheets, profit and loss statements and financial notes - in order to assess a company's performance and future prospects.

Yet, in 2004, the International Accounting Standards Board (IASB) announced in its "Framework for the Preparation and Presentation of Financial Statements" that this information is not enough to meet the objectives of financial reporting. Firms, it says, must report additional information that explains the main trends and factors that underlie their development, performance and position. The American Securities and Exchange Commission (SEC) now requires supplemental information, and the Big Six auditing firms all agree that black and red figures alone paint a cloudy picture.

Customers are the primary assets of many companies today. Firms with contractual relationships, such as Internet or financial service providers, telecom firms, energy suppliers or pay TV broadcasters, can easily determine the number of existing and lost customers at any particular time. This information is important for those who manage the business - and it's also important for investors.

In the paper "Customer Equity: An Integral Part of Financial Reporting," marketing professors Thornton Wiesel of VU University Amsterdam, Bernd Skiera of the Johann Wolfgang Goethe-University Frankfurt/Main, and Julián Villanueva of IESE Business School explain that firms should report "forward-looking customer metrics" to help investors assess a company's performance and its future prospects. Forward-looking customer metrics refer to the value of the customer base and how it changes over time.

"If customer metrics are reported, marketing just might reenter the boardroom discussion, since the information aligns customer management with corporate goals and investor perspectives," write the authors.

Just looking at a company's current profitability is not enough, and here's why: Assume that a company with contractual relationships reports the metrics for two consecutive periods. The data shows that management has done an excellent job, boosting total cash flow by 32 percent. This is the kind of information that is frequently reported.

Yet, if the firm had reported the next two rows of metrics (the number of acquired and lost customers), the picture becomes less rosy, since the number of losses increased substantially. Evaluating whether the management has done a good job is difficult. In this case, investors should ask management why it created short-term value at the expense of long-term value.

Criteria for Financial Reporting

International and U.S. accounting standards are similar in many respects, and the paper focuses on five characteristics that are critical for financial reporting and common to both. They are relevance, reliability, comparability, understandability and cost effectiveness. Forward-looking customer metrics must be consistent with these criteria. The paper then proposes a technique to report the value of the customer base and its development over time.

To make sound decisions, investors need the following information:

- customer metrics, e.g., customer retention and customer cash flow;
- the value of the customer base, usually operationalized as customer equity;
- components of customer equity, e.g., customer equity before marketing expenditures, total lifetime acquisition expenditures;
- changes in customer equity and components of customer equity over time;
- the effects of changes in customer metrics over time.

In general, write the authors, customer equity reporting should comprise two main elements: the "Customer Equity Statement" and the "Customer Equity Flow Statement."

The first, the "Customer Equity Statement," reports customer equity (the value of the customer base) and its components in a clear, single display.

The "Customer Equity Flow Statement" describes changes in customer equity and its components between two periods and reports the influence of any changes in customer metrics on customer equity.

An Example: Netflix

The paper applies this reporting technique to Netflix, whose principal activity is to provide online movie rental services through access to more than 55,000 movies, television and other entertainment titles. Netflix's standard subscription plan gives customers up to three titles at once with no due dates, late fees or shipping charges. Shipping and receiving centers throughout the United States deliver the DVDs through the U.S. Postal Service at no charge to customers.

Because Netflix is listed on the NASDAQ, it must fulfill several SEC requirements, which are described in "Management Discussion & Analysis" and are required in the United States. Consequently, it provides information about customer churn and customer acquisition costs. It also notes that management not only reviews churn rates to evaluate whether the company is retaining existing customers, it also reviews acquisition expenditures to evaluate the efficiency of marketing programs for acquiring new customers.

Using publicly available data on Netflix from September 2001 to September 2006, the paper calculates Netflix's customer metrics and reveals trends in the company's customer equity. These trends allow investors to evaluate the firm's ability to solve the problems of previous periods and its potential to outperform previous growth in customer equity.

"We believe that if more firms follow the example of companies such as Netflix and disclose better information about their customer base, models for calculating and decomposing the value of the customer base (i.e., customer equity) and customer-based firm valuation will gain more importance in practice."

The reporting technique proposed by the paper is a starting point for considering the value of the customer base in a firm's financial report. It supplements and complements current information in financial statements, as demanded by the SEC and the IASB.

Forward-looking customer metrics are a necessary and useful managerial tool that can make investor decisions a whole lot easier.

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