

The critical importance of key customer profitability

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Introduction

Like any other business strategy, key account management is designed to make profits. In reality, whether it optimises a company's profits overall, compared with other strategies and investments a company might make, is probably an impossible question to answer, but possibly no more or less difficult than assessing the profitability of any of those other strategies and investments. However, since companies exist to make profits, the least that would be expected is that they make some attempt to assess where they are making and losing money. Logically, evaluating key account management must be based on the profitability of each of the individual accounts which are receiving the treatment. Although they may be large, they should not be numerous, so making their profitability visible should not be too onerous. It is curious, then, that so few companies have effective measurement of key customer profitability in place.

This paper seeks to establish why it is important that companies should know how much they make from each of their key accounts, why few have made the effort to find out, how they could address the issue and the value they would gain if they did.

The importance of knowing key customer profitability

The essence of key account management is that the customers selected receive different treatments and offers which are specifically tailored to optimising the business with each of them. Therefore each customer should be receiving treatment that has different costs and different outcomes from that received by other customers. It follows that it is unlikely that the profitability of each of these accounts will be the same so, if it is not the same, surely companies would want to know which are giving them a greater yield than others. They can then apply more of what has been successful and take corrective action where the results are poor.

It is through a continuous process of setting expectations, taking action and investigating the outcomes that companies find out what has been successful and what has not, learn from that knowledge and improve in the future. Unless they engage in this classic learning cycle, they are likely to make the same blunders time and again, even without knowing which of them actually were blunders.

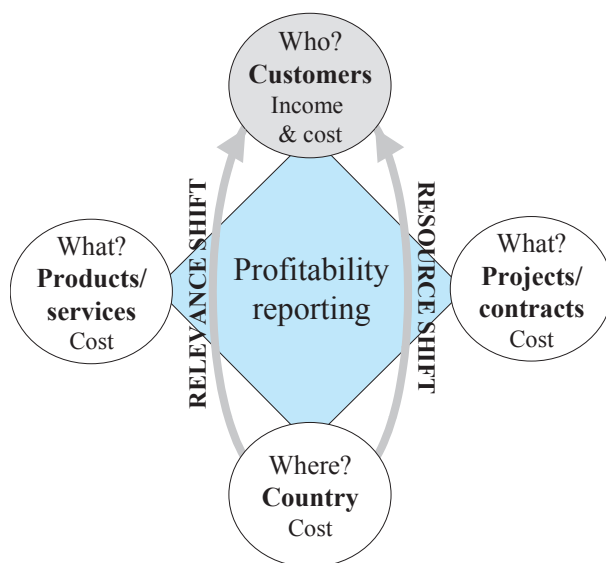
Several authors have challenged the assumption that key account management guarantees higher profitability (e.g.: Kalwani and Naryandas, 1995; Ivens and Pardoe, 2008). Some customers are good at bargaining back any savings made on their business, others consume large amounts of internal resources, and in some expected sales growth does not materialise. Research has shown that companies can easily be mistaken in their expectations of key customer profitability (Woodburn 2004, Bradford et al, 2001). For example, customers that the supplier 'likes' are often in frequent contact and consuming a lot of profit-reducing resources or, again, so-called 'large' customers may be buying big volumes of low margin products, resulting in minimal profits. Which is all the more reason why any supplier should have proper profitability figures.

In the absence of this information, suppliers are in grave danger of misunderstanding which customers give them a poor return and spending more time and money on them, while neglecting customers who give them a better return and may therefore be appealing to competitors. It is reasonable to ask why they put themselves in this position.

Barriers to measuring customer profitability

Research revealed a number of cited difficulties (Woodburn, Holt and McDonald, 2004) in collecting the information required to measure customer profitability, both real and imagined. The amount of effort required to collect the data was the most common concern voiced. However, this and other issues with collection of customer data are no more than those associated with collecting product and geography profitability, which almost all companies have already achieved. Indeed, there is a need for a shift in data collection to be more aligned the ways companies will, and have already changed as the figure below shows.

A different emphasis in profitability reporting



Problematic issues raised can be broadly grouped into:

- » Technological
- » Organisational
- » Cultural
- » Individual

Technological

When the original research was conducted, many management information systems would have struggled to collect data across the activities and outcomes of complex customers. However, for some time now technology has been more than adequate to meet the need, and of greater concern is the quality of data captured. To avoid mistrust in the validity of the outputs, the system needs to be largely objective, affording minimal opportunities for staff subjectivity and self-interest.

Organisational

Not only the functional organisation, but also the infrastructure and locations of a company cause some of the most genuinely difficult problems.

- » Functions that need to contribute data (normally on customer-caused costs) see it as a sales function issue, not their responsibility, and do not cooperate.
- » Regions or, in the case of multinational companies, countries can be resistant to providing data to central functions.
- » Data from different sources may not be compatible or delivered in or for the same time period.
- » Suppliers have not always identified and associated the different entities of complex customer organisations and their dealings with them (e.g. mapping HSBC in all its different guises across the world was a major undertaking for supplier – but very informative and useful when completed).

Cultural

Cultural issues stem from the views and beliefs of individuals, but they constitute part of the culture of the company when they are held by a majority of employees, particularly by senior management, and persist over an extended period of time. Business cultures that affect the acquisition of customer profitability information include:

- » Those in which companies do not see any significant differences between their customers (erroneously, according to key account management precepts) so their profitabilities are also assumed to be the same.
- » Complacent companies achieving ‘satisfactory’ results may not see the need for deeper understanding.
- » Where customer driven costs may be seen as insignificant compared with product/project costs.
- » Some people feel they have an intuitive understanding of profitability which they consider satisfactory.
- » Where customer profitability is seen as being highly sensitive and confidential, it may be considered safer if no one knows it.
- » Cultures exhibiting a lack of genuine accountability do not require such information.
- » ‘Blame’ cultures in which transparency is seen as dangerous to individuals.

In the case of mistaken assumptions, a project to genuinely test whether those assumptions are well-founded would solve the matter, but often not even that is undertaken because of the existence of other beliefs, possibly linked to personal fears.

Individual

Some concerns may be considered more personal and cultural, although they are equally common.

- » Older customer facing staff are not always sufficiently competent and comfortable with computers: their data entry is often effortful and hence incomplete and of poor quality.
- » Key account managers like ‘owning’ their customers and may resist what they see as unnecessary monitoring for fear of interference.
- » Key account managers may be averse to recording the time they spend with the customer in case the cost and value of it is challenged.
- » Not everyone wants to know the answer, e.g. “I’m not sure I want to know that (the

profitability of his key customer)... and I'm not sure my manager would want to know either" (Woodburn, Holt and McDonald, 2004), for fear of the consequences of being dedicated to a loss-making or low-return key customer.

All this amounts to a not insignificant barrier to measuring key account profitabilities but, ultimately, few of them are objectively valid. Nevertheless, they do need to be addressed if system set-up is to be successful.

Approaches to key account profitability measurement

Key account management and associated costs

Key account management costs are numerous and generally poorly recognised. They include:

- » Product or service customisations
- » Non-standard production or service needs e.g. overtime on short notice orders
- » Logistics especially where tailored to customer requirements
- » Technical service where not invoiced
- » Heavy use of customer service
- » Exceptional invoicing and finance costs
- » Tailored order processing
- » Developing bids and proposals
- » Specific marketing initiatives
- » Sales/key account management people and their office, transport and communication

Such a range of costs demands a rational cost-allocation method (Gupta and Lehman, 2007). Key customers will, for example, vary in their demands for marketing initiatives; the number and detail of invoices they require and the number they challenge; their expectation of free technical service and product customisations; etc. These all entail real costs, but they have varying degrees of visibility. It is not that hard to recognise the cost of a marketing initiative, but it may be more complicated to agree the cost of product customisations that may involve extra machine downtime, different packaging, or different documentation. For some suppliers the time and hence cost of developing a bid is huge, but it is often 'stuffed under the rug' and rarely attributed to the customer account, especially if it fails.

Some company overheads should not be attributed to individual customers - the chairman and chairman's car, for example, or the supplier's own research and development - but they are considerably less than the overhead commonly applied across the whole business. 'Marmalading' a high overhead across the whole business means that smaller customers and other activities are bearing a burden of costs which they do not incur. In effect, understanding of where the company makes its money is shrouded under a thick blanket of general overhead.

Activity based costing (ABC)

ABC techniques are by no means new, but have not been popular, probably owing to the perception of the amount of work involved in capturing and allocating staff time, and a

general dislike of being accountable for time spent: but it should be obvious that some kind of ABC process is required from the list of significant costs above. A reasonable compromise can be achieved by a combination of project costing and the costing of recurring 'events' with a count of the number triggered by the key customer.

So, for example, the cost of invoice challenge and resolution (an 'event') may be determined initially by an exercise which records the actual time involved in a number of these events over a fixed period. At the end, the average cost of a challenged invoice is calculated. Thereafter the number of invoices challenged by a key customer is counted each month, which is not arduous, and multiplied by the average cost, allocated against the customer's P&L record. Thus suppliers can begin to see the difference in resource demand between a customer who frequently challenges invoices and one that does not.

This modified ABC technique can be used across quite a wide range of recurring 'events' which disturb the efficient running of the supplier's processes. Larger, less routine projects require actual time costing, which is generally easier and more acceptable than these smaller events.

Continuous monitoring

Ideally, capture of key customer profitability would become one of the supplier's routine financial reports, and a few companies have achieved this on a national and even global platform. Failing that, a project that measured key customer profitability over a fixed period, if long enough, would at least represent a 'snapshot' of the profitability of each key customer that would yield important data. It would also offer valuable experience of collecting the necessary information, and it would be very risky to attempt a continuous monitoring system without having first run such a project, so that the issues of data collection and presentation can be resolved in advance of more costly automation. However, just as profitability will vary across different key accounts, it will also vary within one customer over a period of time, and therefore a project that only provides a one-off snapshot is ultimately not sufficient.

Net present value

Comparisons of customer performance are one of the most useful outcomes of measuring key account profitability. Performance or yield should be examined over an extended period of time because, if the supplier is investing in the customer, the apparent profitability may be low or even negative in a single time period. Presumably that investment is made with an expectation of a good return in a later time period, so comparing such a customer with another during the investment period could be very misleading. Checking profitability in the current time or recent past is valid in tracking whether activity is progressing according to expectations, but overall evaluation of customers needs a longer perspective, both backwards and forwards (Lemmens and Vanderbiesen, 2014).

While history is important in forming realistic expectations, key customers' profitability is unlikely to follow linear trends. So the forecast profitabilities are those which should determine investment choices, new activities and cost-cutting actions. Just as investment in other development projects can be assessed by Net Present Value (NPV) techniques, so can investment in key accounts. Shown below is the kind of calculation involved. The time period concerned differs across different sectors, but should be a minimum of three years (sectors with high capital cost projects apply 5 to 20 year periods or even longer): it may easily take a year or more to make an investment before any consequent return can be expected. If the assessment window is cut off short at only a year or so, the return on investment can be seriously undervalued.

Example of NPV calculation for a Key Account

€m	This year	TY+1	TY+2	TY+3
Revenue	6	7	10	12
Gross margin (Revenue - direct product cost)	2.4	2.8	4.0	4.8
Probability of achievement %	100%	90%	75%	65%
Probability adjusted GM	2.4	2.52	3.0	3.12
Cost to serve	0.3	0.4	0.5	0.5
Specific investment costs	0.1	0.3	0.1	0.2
Contribution (GM – all customer specific costs)	2.0	1.82	2.4	2.42
Discount factor (at 10%pa)		1.1	1.21	1.331
NPV: Discount rate adjusted contribution (Contr/DF)	2.0	1.6	2.0	1.8
3-year NPV (Total TY+1, TY+2, TY+3)	5.4			

The past is really only useful to managers to the extent that it informs their views and decisions about the future, since they can only influence the future. Where investment for customers is limited, using the NPV approach allows the supplier can make better decisions about which customers should be resourced.

Furthermore, since key accounts often make up a substantial amount of a supplier's business (anywhere from 20 to 90% of profits) then this evaluation for all key accounts gives the company a very good indication overall of what profits it can expect in the future, and when.

The value of measuring key account profitability

The specific purposes of measuring key account profitability are the same as those of any worthwhile measurement system, defined as follows:

- » to make strategic decisions
- » to track progress
- » to improve efficiency and productivity
- » to gain visibility
- » to learn and improve.

Making strategic decisions

Knowledge and experience of the past in each customer, in terms of costs, returns and overall profitability, is crucial in making realistic forecasts for the future. In the absence of that data, overly optimistic forecasts are often produced, sometimes because significant costs have been overlooked, or because improbable growth rates have been applied. Excessively optimistic forecasts lead not only to disappointment, but also to wasting resources on customers where the future returns may not be good enough and failing to identify declining markets. On the other hand, potential key accounts arising in new markets may go unnoticed. Companies are understandably reluctant to take major strategic decisions without evidence to support them, and some of that lies in the profitability of key accounts.

Tracking progress

Shorter term assessments of profitability are also useful. The data can show when forecast returns have been received and whether they are owing to an uplift in sales or a cut in costs. It can also confirm whether planned action has been taken or not, since action generally attracts cost. Companies often intend to take action that they actually fail to implement, or implementation is late, and it can be difficult for the key account manager to find out what has happened. If the data collection system is working as it should, such delays and omissions will give rise to discrepancies that should become obvious so that remedial action can be taken. Companies must respond to customer profitability data, as well as producing and monitoring it.

The individual key account manager should be concerned about tracking the progress of profitability against plan in his or her key account, as they should be responsible for it. Ultimately, the supplier company is probably more concerned about whether the overall portfolio is performing as expected, rather than individual key accounts, but it is hardly safe to have these amounts of business running on autopilot without proper data on what is happening with each one.

Improving efficiency and productivity

Some suppliers now make the key account manager responsible for customer profitability. While they are not responsible for many of the costs of delivery to key customers' expectations, they should be responsible for the overall direction and management of the account, because no one else in the supplier has, or can have, that responsibility. Therefore they need to closely monitor the overall result of all the activities with a key account, in order to ensure optimum performance across all activities.

Strangely, some companies expect the key account manager to do this job without providing them with the data. In some cases, customer gross margin is used as a poor representation of profitability; in others Board members have access to the information but the key account managers do not; and sometimes this apparent accountability is attached to an unsubstantiated notion of profitability, unsupported by any data.

Gaining visibility

Real data constitutes a powerful way of communicating the importance of key customers to an organisation; to its Board, to all its functions and to the key account managers themselves. Businesses normally respond to numbers, and many key account managers would have had a much better response to their needs from senior management and other parts of the company if they had been able to show the full financial situation, for better or for worse. Situations in which key customers are making a loss for a supplier have been identified by a number of researchers, even where suppliers have been reluctant to face the possibility.

When the German chemical company Henkel (Bradford) researched its key customers some time ago, it found that its existing perceptions of customers was a very poor basis on which to invest. Apparently 'good' customers did not necessarily provide a good return, while some of their 'difficult' customers were financially much more rewarding. Had they known sooner, they would have changed the treatment they offered to these customers. A travel company that investigated the profitability of its key customers was able to make a substantial difference to overall company performance.

In contrast, sales figures are very visible and accessible, so many companies target and assess the performance of their key account managers on sales (Woodburn, 2008). Since there can be a major gap between sales and profit, particularly in the case of key customers who are tough on price and expensive to run, targeting against sales performance can actually be dangerous. Furthermore, unless the profitability of their customers becomes visible to key account managers, they are unlikely to change their conviction that their job is to increase sales regardless of the cost.

Learning and improvement

Key account management is resource-hungry: it requires new, tailored initiatives for key customers, which means investment, and since no company has unlimited resources, suppliers will need to make choices. In making such choices between key customers, profitability histories provide invaluable information on responses to and outcomes from past initiatives from which the company and all its key account managers can learn.

Companies need systematic ways of capturing qualitative information with potentially causal implications alongside customer profitability, and of sharing information about the activities, responses and outcomes associated with key accounts. A positive and open approach to the discussion of these issues allows lessons to be learned and performance improved in the future. Unfortunately, that opportunity is often lost because of the secrecy and sensitivities surrounding these customers.

Conclusion

It is difficult to imagine that companies would manage so much money in any other area of their business with so little information. The case for having good knowledge of key customer profitability seems solid, and yet, even now, relatively few companies are actually in possession of it. At SAMA's (Strategic Account Management Association) 2014 European conference, representatives of some major global companies were still sceptical of the value of this knowledge. Where this attitude is prevalent, there may be as little progress on this issue in the next few years as there seems to have been in the last 10 years, since our original research on key account profitability (Woodburn, such as Holt and McDonald, 2004).

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