Implementation of Customer Profitability Measurement

Dealing with Challenges in Practice

by Kai Eric Hoffmann and Lothar Renner

The following article gives an insight into practical experience of implementing a customer profitability measurement in a large group of companies of food-processing industry. The undeniable theoretical benefits of the **customer profitability measurement as an important controlling tool** will be taken as a starting point for presenting initial stages and practical difficulties that arose during its actual implementation. Thanks to the ultimately successful implementation of the customer profitability measurement and the fact that it has remained robust after some considerable period of time, the article also presents the case-specific solutions to typical difficulties.

Basics

The article deals below with the theoretical foundation of the customer profitability measurement. However, this part is intentionally kept short because it concerns a well established concept and there is plenty of literature available for further academic studies (e.g. Weber, Haupt, Erfurt – Kundenerfolgsrechnung in der Praxis)

Background and Objectives

Nowadays many markets are highly saturated and at the same time lacking in innovations. Obviously, this fundamental development of the last two decades has also had an impact on controlling. That is why there has been **more focus put on the customer as a controlling object**. Nowadays customer satisfaction, brand loyalty, market share ratios or winning new customers are an integral component of management reporting in many companies. These ratios are not only regularly measured and analyzed, but they are also taken into account when granting compensation packages for management staff. In this context the customer profitability measurement considerably grows in importance. Even if the other mentioned ratios are essential and can provide excellent management information, **it is after**

all crucial, if we make any profit with our customer and how much.

According to the Kaplan / Narayanan[2] study conducted in 2001, the most profit is made with only 20% of customers (cp. image 1).

That makes it immediately clear, how important it is, to gain more transparency in matters concerning the value of individual relations with our customers. This transparency can be used to further develop specific groups of clients. The gained information can also contribute to **considerably more target-oriented discussions with customers**. The aim of negotiations is to find out which customer performances are not appropriately rewarded and to negotiate them more specifically rather than to discuss customer's contribution.

Conceptual Considerations

The objectives of the customer profitability measurement are not only marketing costs that can be fairly quickly and precisely calculated, but also presenting the so-called indirect marketing costs. Indirect marketing costs mean such costs that are not necessarily directly related to the customer. To the indirect marketing costs belong here not only fixed costs, but actually all kinds of costs, such as costs of freight (these costs cannot or can only be very inaccurately allocated to individual customers, for example a consignment covers the whole route and the costs of an individual customer depend on his location on the route). In the language of stepwise contribution accounting these would be called "customer-fixed" costs.

The difficulty by implementing this concept lies quite clearly in estimating individual marketing costs on the level of individual customers. While the direct marketing costs can be immediately calculated - since these are literally "directly" allocated to a specific customer - **indirect marketing costs can often be classified only in relation to customers.** In solving this problem the theory often proposes to use techniques of activity-based costing in order to relate hidden costs to the customer who generates them.

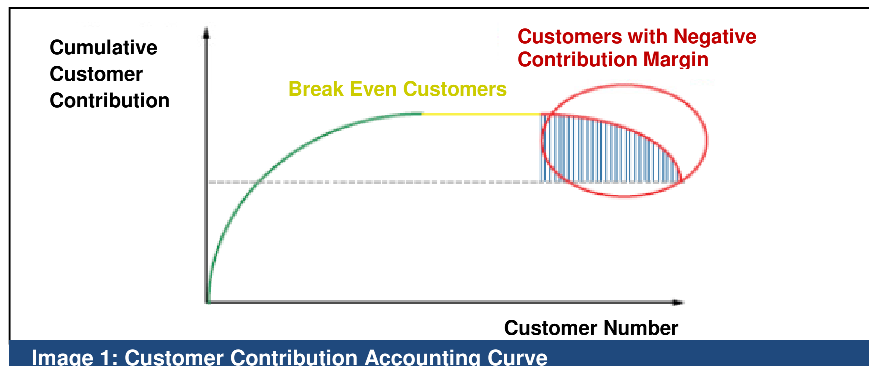

Image 1: Customer Contribution Accounting Curve

That is why it is advisable (e.g. Santori/Nagel[3]) to proceed according to the following four steps, which do not differ conceptually from the traditional activity-based costing:

1. Identification of relevant customers

This step may sound trivial, but it is actually a crucial stage serving as a starting point for further considerations during which the most fundamental decisions have to be made. Among other things, in this step we need to decide if certain groups of customers are at all to be included in the analysis and on which level "customers" are to be defined.

2. Defining cost drivers

At this stage we are supposed to identify indirect cost categories and to determine respective cost drivers. For instance, a customer service could treat the number of calls or customer visits in a call center as a cost driver.

3. Relating cost drivers to customers

The purpose of this step is to relate the above defined cost drivers to customers. At this stage measurement tools are determined – so that in the above mentioned example the number of customer visits can be obtained by means of queries during field services. On the other hand, the number of calls in a call centre cannot be so precisely measured as call centers are normally bulk businesses which operate in an industrialized form and have no time planned for recording answered calls.

4. Calculating customer profitability

Basing on the preceding determinations this step builds up purely mathematically customer profitability measurement. In the process the costs will be driver-based allocated to individual customers in order to calculate profitability.

The next part discusses the ways of putting this theory into practice.

Practical examples of customer profitability measurement implementation

The following text discusses the implementation of a customer profitability measurement in a company of food-processing industry. Market environment of the company in this case is characterized by

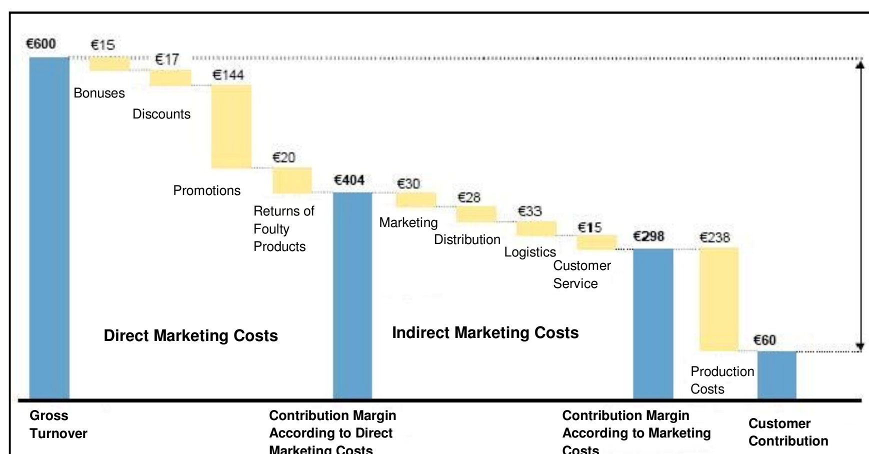

Image 2: Example of a Gradual Customer Contribution Accounting

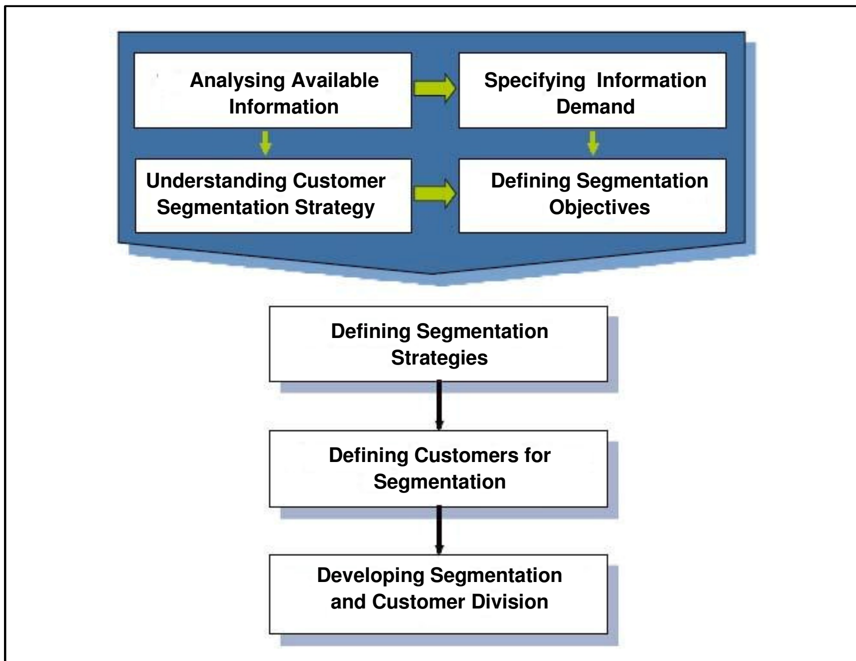

Image 3: Customer Segmentation Procedure

high saturation on the main markets in Western Europe and America. Due to increasing concentration at the consumer end (Supermarkets such as Wal-Mart, Metro, Edeka), **the increasingly stronger pricing pressure is noticeable**. The growing power of the consumers is also noticeable in the increasing number of demands for concessions that are not bound to price, such as promotional bonuses, allowances for sales brochures etc.. At the same time the industry is distinguished by very high gross margins (sales revenue less direct production costs), so that historically the emphasis was put on maximizing sales.

Initial Situation

The concept of a customer profitability measurement was implemented as a component of a value creation program across a group of companies. The program included, for example, the following subproject: use of shared services in finance and purchasing areas and implementation of a globally standardized SAP system (ERP project). As customer profitability measurement was closely connected with the ERP project, it was organized as a part of ERP harmonization. The purpose of that was to make sure that controlling requirements from the transactional system can be met for the customer profitability measurement.

Basic Concept

The fundamental determination at the beginning of the project was a principle according to which the concept that is to be developed would have a global character and **its implementation would be mandatory for all companies in the group**. That guaranteed that the previous "rank growth" of controlling conceptions was ended and that each company provided profitability calculation on the basis of the same determination. In addition, it made it possible to create a profitability measurement for global key accounts across all companies of the group. Since there is plenty of information available on the side of the key customers in supplier controlling, **the implementation of the customer profitability measurement was strongly supported by the key account management**. The objective was to achieve stronger negotiation positions with the help of better information.

However, this global operation led to quite a practical problem: business models sharply differed in various countries and customer relations were also accordingly different. So there were countries with business relations consisting of fewer intermediaries, whereas in other countries customers comprised of retailers. Moreover, there still existed certain fields of business which were covered only with distributors.

It made obviously no economic sense to develop a profitability measurement for small customers – the administrative costs of developing and analyzing these figures would by far exceed the actual profit. The same conclusions would be made for customers with distributors only – in this case the contracts are drafted in such a way that the distributor bares no indirect marketing costs that would be worth mentioning. Customer contribution to distributors was here de facto already available and there was no reason for further actions. Basing on the proceedings presented in image 3, it was now decided that the customer profitability measurement must be implemented for global, regional and local major customers (key accounts) as well as for selected customer groups (e.g. restaurants, retail trade).

The very thing that was heatedly discussed were partial restrictions to the profitability of customer groups because the operation was perceived as too "rough" and therefore of little benefit. This was a pragmatic compromise, especially if you consider the fact that for some countries every other solution would have led to unbearably high costs of gathering information. It is certainly worth noting that **focusing on customer groups was a minimum requirement only in case of a group of companies** – a few countries dissolved the customer groups further into individual customers during the actual implementation.

Challenges and Approaches: Customer Profitability Measurement without Process Costs Orientation

The conceptually biggest problem during the implementation of the customer profitability measurement was the fact that the operation included no process costs calculation. That is why there were no defined services and output quantities, which would have been helpful in allocating the costs more accurately. There was also no sponsor to be

found in financial organization who would be ready to comprehensively implement a process costs calculation and to accept efforts and changes involved. For that reason we could not include all the costs positions which should be perhaps - from the controlling point of view - allocated on customer level. In addition, we had to accept the fact that the positions taken into account possessed a high degree of inaccuracy.

One advantage of the decision to abandon the upstream implementation of the process costs calculation was greater eagerness of the countries to implement the customer profitability measurement. It was facilitated by considerably more advantageous cost-benefit ratio and the fact that the time pressure for respective countries could be kept in limits.

Components of the Customer Profitability Measurement: Discounts, Bonuses and Promotions

The most important position (measured at volume) of the profitability measurement was to inclusion of benefits and allowances given directly to customers. These are especially the discounts which are granted already in the invoice. Taking these positions into account directly from the invoice raised the question of costs calculation for customers. The situation with bonuses may be similar, but these are granted first ex post and are not booked directly on customer level. However, the standard ERP systems such as SAP give **after each transaction with the customer the possibility of provision in the amount of expected bonus** (e.g. with the combination: 2% bonus after reaching a sales target), which are then automatically allocated in the system with the mark "customer", so that the data are directly available for reporting purposes.

This is also the case of bonus agreements that were agreed upon with buying groups (such as Edeka). Although the contractual agreements were reached here with the buying groups, the booking of provisions takes place in SAP and for individual members of the buying group, since these are - from the point of view of controlling - the relevant customers, in whom we invest.

The **booking of lump bonuses** that are granted regardless of transactions (e.g. loyalty bonus 10.000 Euro annually) is integrated in the system by means of so-called lump agreements created for this purpose. There were appropriate provisions directly booked for them – in compliance with recognized financial reporting requirements –, which were also marked as "customer".

It was harder to allocate **promotion costs to customer level.** The case of directly granted allowances (e.g. payment to customers in order to include own products in the promotional materials) posed no problem because the allocation to customers was immediately possible. However, promotional expenses that are supposed to be covered not only for a single customer, have to be also considered – e.g. costs of promotional materials which are given away over the time ex warehouse to various customers and are directly booked into the costs while purchasing. Expenses for general promotion such as TV ads also belong here.

These two examples show that we can distinguish two fundamental cases:

- costs independent of customers and
- not directly and/or only hard to be allocated costs

In the first case a customer profitability measurement is plainly out of the question. In the second case arises the question how economical the appropriate allocation is in individual cases, or when an allocation provides controlling-relevant information (e.g. when a marketing field employee leaves promotional material such as ballpoints, lighters etc. during customer visits, a customer-related allocation could be theoretically possible, but it would lead to excessive costs during the registration).

In that specific case this question was resolved by applying a customer-related registration of advertising and promotional materials each time, when a single advertising article had the value of 50 USD in purchasing. This determination was based on the analysis of an average value of the used advertising materials. It had to be precisely registered, which customers received higher value advertisement materials registered in the described way. As mentioned above, since the purchase was already appropriately booked, the question arose how to precisely allocate these costs to the customers. The separation of internal (SAP-CO) and external accounting (SAP-FI) was useful here: while invoicing in internal accounting (SAP-CO, income statement) the costs rebooking to the account client was carried out. As this rebooking took place only in the "CO module", there was no change in profit and loss accounting. There was a further possibility guaranteed to balance external and internal accounting as only mark allocation to the account was added (no value change).

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Freight, Customs and Insurances

Customer specific costs including freight, customs and insurances were defined as a component of the customer profitability measurement. As third parties were in charge of the whole delivery procedure, only direct costs were taken here into account, so that **no classification of internal costs with all the upcoming problems** (dealing with idle capacity costs, full costs and part costs calculation etc.) was necessary.

Ideally, it was possible to retrieve customer-related costs in SAP-system – this concerned in particular key customers, for whom the deliveries were always customer-related. Here, freight accrued expenses were already included in each SAP customer order. As logistics service providers issued invoices always in relation to deliveries, it was also easy to distribute potential inaccuracies between the planned and actual freight costs to the respective customers.

It was more difficult when more deliveries to various customers were done during the same route. Logistics service providers would usually issue invoices for the whole route without taking into account route segments to the individual clients. Even if a detailed invoice had been provided (e.g. the bill as per kilometers, from which transport costs for each customer could be calculated), such information could not have been used for the customer profitability measurement. It is namely not justified to grant a customer proportionally lower freight, customs and insurance costs, only because he happens to be located favorably on the given route and there is small distance between him and the previous customer.

For this reason it was agreed that the costs were calculated according to gross weight of the respective customer deliveries. It was the most proper approach because one of the main cost drivers in the logistic processes is the weight of the load. It applies far less to customs and insurances as these costs depend rather more on the value than on the weight. Also here transport costs themselves created a far bigger block of costs. That is why it was decided against the implementation of this proper classification criterion here (as e.g. value of goods). Thanks to that customer profitability measurement could be very easily kept structured and the expenditure for cost distribution / classification could be kept low.

Handling Costs

On the last position of the customer profitability measurement were the so called “handling costs”. By this we mean such **costs, which arise in direct logistic processing of customer orders** (so for example commissioning, route planning and inventory costs). These costs together with the given resources were not assigned directly to the individual customer or customer order. Instead, it was considered which costs driver was ultimately decisive for the majority of these handling costs: the analysis made together with the logistics departments from some countries showed **that costs and order size were closely related**. At the same time, however, it had to be noted that in spite of the fact that key orders in total terms incurred higher costs than small orders, the cost of the single product actually sank.

It appears perfectly obvious – while the key orders processing is in absolute terms more time consuming (more commissioning steps, higher proportional inventory costs due to larger quantities), the key orders do gain profit from considerable economies of scale and fixed costs reductions.

The order size was appropriately selected as a cost driver in “number of pallets”. All logistics costs in the warehouse were determined as a costs base. Because there were activity differences in the warehouses between the countries, we made the following adjustments: as inventory costs **we defined all costs that arose between the receipt of the order from order acceptance and loading of the goods to delivery, including handing over the freight papers.** That is why some countries had to use the costs positions from various organizational areas while calculating the costs base (e.g. when the route planning was organizationally assigned to order acceptance).

Two tariffs were assigned to this base: **a (lower) costs rate for orders with more than ten pallets and a (higher) costs rate for orders with fewer than ten pallets**. This approach was obviously simplified because not all components of the costs base could be assigned solely to the costs driver “number of pallets” – insurance costs for the warehouse depend, for example, wholly on value. Besides, defining a limit of “ten pallets” is also highly disputable. As it was already mentioned above, by choosing these definitions we were guided by the fact that the concept had to be simple, clear, generally acceptable and sufficiently precise. The latter could be confirmed with the help of analyses and simulation basing on data from two countries. So the customer contribution accounting presented in image 4 was a good example.

Not Included Costs Positions

As already mentioned, there were no activity-based costings available that could serve as tools for more precise costs distribution. That is why some costs positions were not allocated to customers. In addition to the already mentioned general customer-specific advertisement costs, that was especially the case of all costs of customer services, internal sales and field services. Due to the present marketing structure that rarely included dedicated key account managers, it would have been necessary here either to conduct a detailed analysis of respective operations and activities, or to choose a very comprehensive costs distribution mechanism. The fist solution was out of the question since it deals after all with process costs-oriented operations that were not desirable. The second solution was rejected because as oppose to handling costs there was no “approximately” right, easy to calculate

Customer Main Group X1										
Customer Group		Supermarkets				Specialist Shops				X1
Customer		Customer 1	Customer 2	Customer 3	Total	Customer 1	Customer 2	Customer 3	Total	Total
Gross Revenues		11,000	12,000	13,000	36,000	21,000	22,000	23,000	66,0000	102,000
-	Decrease in Revenues (discounts, bonuses)	-275	-300	-325	-900	-525	-550	-575	-1,650	-2,550
-	Promotions	-800	-745	-150	-1,695	-600	-135	-995	-1,730	-3,425
=	Net Revenues (Customer Contribution I)	9,925	10,955	12,525	33,405	19,875	21,315	21,430	62,620	96,025
-	Freight, Customs, Insurances (variable customer-related costs)	-495	-630	-780	-1,905	-1,575	-1,815	-2,070	-5,460	-7,365
=	Customer Contribution II	9,430	10,325	11,745	31,500	18,300	19,500	19,360	57,160	88,660
-	Handling Costs (indirectly customer-related variable marketing costs)	-833	-270	-520	-1,623	-245	-300	-310	-855	-1,465
=	Customer Contribution III	8,597	10,055	11,225	29,877	18,055	19,200	19,050	56,305	87,195
-	Manufacturing Costs	-3,300	-2,500	-4,000	-9,800	-5,000	-3,800	-4,500	-13,300	21,600
=	Customer Contribution IV	5,297	7,555	7,225	20,077	13,055	15,400	14,550	43,005	65,595
	In % of Gross Revenues	48%	63%	56%	56%	62%	70%	63%	65%	64%

Image 4: Examplary Customer Contribution Accounting

costs driver available here. **In order to prevent the customer profitability measurement from being diluted by too rough distributions, the idea of them was completely abandoned.**

Integration in Control Systems

The marketing staff involved in the project broadly welcomed and fully supported the concept of the customer profitability measurement. Thanks to that a certain project dynamic was developed, which was characterized by firm pressure and early plans' realization. In retrospect, we have to admit that because of that one important point remained too long ignored and cropped up when the project was already highly advanced: it was namely the integration of the customer profitability measurement in an overall controlling system.

Traditionally marketing was primarily controlled on the basis of turnover, gross margins and sales targets. At the first glance the customer profitability measurement could have been interpreted as a new important KPI providing further controlling impulses. However, the second glance shows that an undifferentiated application of a profitability measurement can lead to false impulses in controlling:

There can be namely entirely "unprofitable" customers, whom we nonetheless want / have to serve for strategic reasons (e.g. in order to develop brand awareness or to go along with competition). Treating the customer profitability measurement in an undifferentiated way here would drive away these unprofitable, but strategically important customers: one result that is undesired from the overall corporate point of view! Moreover – as usually by costs classification – there arose the question: to what extent costs positions can be influenced and the profitability measurement can provide controlling impulses.

It is indisputable that the above considerations are of little relevance on the level of sales management, since that could require a comprehensive controlling tool. That tool shows an overall view that can be used for making strategic decisions. That is why the customer profitability measurement was integrated into the scorecard for every "sales director", and there was one such director in each country. Because this scorecard involved further strategic target indicators, the target conflicts such as "unprofitable" customers were not supposed to be served and to a great extent even eliminated.

More difficult is the implementation of the customer profitability measurement on the marketing staff level. Fundamental was the question, if it is not enough to grant marketing access to the customer profitability measurement only to directors and to let them, with the help of it, set objectives for marketing field service. The question was fundamentally negated as **the target of the project was to implement a value orientation in the whole company**, and that was supposed to remove the previous mantra of "growing at any price".

For that reason the customer probability measurement was operationalized on the staff level in two steps: first, a **consequent segmentation of customers was carried out and in each customer segment there was implemented a profitability measurement.** Since the marketing targets were distributed on the segment level, there was no danger of omitting strategically important and unprofitable segments. **At the same time, however, the profitability measurement highlighted on which customers *within* a segment the focus should be placed.**

Image 5: Examplary Customer Dashboard, highlighted Customer Contribution Monitor

This idea of a relevant customer profitability measurement was developed to such an extent, that the management always received, instead of absolute profitability measurement results, just a relative ranking within the customer segment. In such a way the staff should be prevented from "clinging" to a certain costs positions that probably cannot be influenced at all, and from holding fruitless discussions with customers. The ranking was depicted with a simple traffic light system.

In addition, while reporting (Qlikview was in use) there was a component taken for the customer contribution accounting within the existing customer dashboard. This dashboard (cf. image 5) enabled the key account managers to get, at the first glance, all relevant customer information. Please note that the staff received no such tool for influencing profitability of certain customers by means of targeted measures. This was obviously not considered as a target in the given market circumstances and also not within potential of individual sales representatives.

Conclusion

It is indisputable that a customer profitability measurement can provide important controlling information. However, only in case when the data about each customer can be collected with sufficient accuracy – otherwise we get a more or less random statistical distribution. Such information will not be credible for the company and its value for the company management could be questioned.

Especially in the companies which cannot rely on process-cost-oriented controlling, the implementation of a customer contribution accounting poses great difficulties. Without process cost analysis many kinds of costs can be allocated to the customer level indeed only with difficulty (that means ultimately randomly to a certain degree). As a result the practical value of a profitability measurement is limited.

We learned from experience **that during the implementation pragmatic approach is crucial for success**. One also has to distance oneself from academically welcomed, but hard to achieve results. There are no universally applicable solutions because in each company different cost positions are important and the configuration of available ERP-systems determines data accuracy. As long as one is aware of the made compromises and of the related limitations, customer profitability measurement provides a further useful controlling tool.

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Footnotes

[1] Weber, et al

[2] Kaplan, Narayanan – Customer Profitability Measurement and Management, 2001

[3] Santori, Nagel – Customer Profitability Analysis, Charter Consulting, 2005