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HBR CASE STUDY

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biggest accounts. *by Robert S. Kaplan***

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As Tommy Bamford and Jane Oldenburg drove into the visitor section of Westmid Builders' car park, Jane pointed out the man they had come to see: Steve Houghton, Westmid's purchasing executive. He was in front of the headquarters building, waving a greeting. Jane waved back to her friend, whom she had known for decades, but Tommy scowled. He wasn't looking forward to this visit. "Oh, come on," Jane said, nudging him. "Look how friendly he is."

Tommy was a director and Jane was the Midlands regional sales manager for Egan & Sons, a supplier of doors and staircases to Westmid for 63 years. The two executives had to pause before crossing the gravel road that ran through Westmid's grounds, because of the steady stream of trucks traveling to and from construction sites around Birmingham and all the way to London. Tommy knew that despite the heavy traffic that April morning, Westmid was hurting from the economic downturn in the UK. The company was building only half as many housing units this year as it

had during recent boom times. With the steep falloff, Westmid was no longer Egan's biggest customer, but it still retained considerable clout. Too much clout.

"I'm flattered by such an august delegation," Steve said. "Shall we start with a tour?" Jane, a tiny and exuberant blonde with a boy's haircut, happily agreed. She had been here many times, of course, but Tommy was not a regular. Steve chatted away as he shuttled them in a little electric vehicle past warehouses and outbuildings.

Jane had promised Tommy that a visit to Westmid would change his view of the company. But he could not shake his newfound awareness of how much money Egan was losing with Westmid—the account's ratio of operating income to sales was a negative 28%. The two companies had enjoyed a smooth relationship for decades, but Tommy strongly believed the time had come to terminate it.

Steve kept glancing at Tommy during the tour. "You look pale," Steve said at one point. "I hope my driving isn't making you queasy."



HBR's fictionalized case studies present dilemmas faced by leaders in real companies and offer solutions from experts. This one is based on the HBS Case Study "Elkay Plumbing Products Division" (case no. 9-110-007), by Robert S. Kaplan.

ILLUSTRATION: JORGE AREVALO

EXPERIENCE

“That’s quite all right,” Tommy said. “I’ve got a strong stomach.”

The Power of Customer Costing

Egan & Sons, founded in Birmingham in 1908, was hardly a sleepy company. With three efficient plants staffed by 3,000 employees, it had reinvented itself to become an innovative manufacturer of modular steel staircases and fiberglass doors. Its accounting system, however, remained simple and traditional. The weaknesses became apparent only in the mid-2000s, when Chinese companies began to encroach on Egan’s low end, severely undermining profitability.

With careful study, Tommy had figured out that the company’s costing system had made it blind to its own operations: It allocated factory overhead to products as a percentage markup over direct labor costs, and corporate overhead as a percentage of sales. Thus, the company could not accurately identify its costs for serving individual customers or for designing and producing all the new goods it had recently brought to the marketplace. The lack of traceability and transparency extended to the costs for specialized equipment that was used only for particular products or customers.

Tommy, an avid reader of the business literature, wanted Egan to adopt an activity-based costing, or ABC, approach. Enlisting several younger financial managers, he made the case to the executive director, Wilfred Hammond, who approved the hiring of a consultant with extensive experience in ABC. Tommy and the consultant assembled a team that began by identifying the costs associated with each customer order, through all stages: bidding, raw-materials purchasing, production and delivery, and invoicing and collection.

With 6,000 SKUs and 2,500 customers, the team had to crunch reams of data, but the basic ABC process was straightforward: Calculate the hourly (capacity) cost of the resources that performed each sales, production, administrative, storage,

and distribution process and the time that each order required at each stage. Before long, the team could pinpoint the cost of every process performed for every customer and could trace revenue deductions—discounts, allowances, promotions, and returns—back to individual customers. Those deductions, which totaled 12% of sales, had previously been collapsed into a single line item in the P&L for each customer.

At one point, Hammond had grilled Tommy about why the project was taking so long and costing so much. Tommy responded that the time and care were critical to producing valid, defensible numbers from which he could initiate candid discussions with the least-profitable customers. Tommy also hoped to identify

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Egan’s most profitable customers so that sales managers might extend and deepen relationships with them.

The Art and Science of Rationalizing

It took four months for the ABC project’s initial findings to emerge. And they were shocking: Just 1% of Egan’s SKUs accounted for 100% of its operating profits. The most profitable 20% generated more than double that amount, but the extra gains were canceled out by the company’s unprofitable products, which generated losses equivalent to 120% of profits. The customer story was similar: The most profitable 1% of accounts generated 100% of profits, and the top 10% accounted for nearly double that amount. The remaining 90% of customers were either break-even or a drag on the bottom line.

So Hammond formed a management team to take action on the large number of unprofitable products and customers. At a “SKU rationalization meeting,” the team classified its money-losing SKUs into four action categories: drop, reprice, redesign, or take no action (for products that had been ordered by important customers or were unprofitable only because of internal process inefficiencies). The company soon had a plan to eliminate or modify nearly half of its 6,000 SKUs.

Tommy chaired a subsequent “customer rationalization meeting,” which he hoped would yield a similar consensus: that Egan should sever ties with its loss-making customers—especially the least-profitable 1%, among them Westmid, whose accumulated losses had cost Egan 40% of the company’s profits.

Hammond was traveling and unable to attend the meeting, so Jane had monopolized it. “Customers aren’t SKUs—they’re relationships,” she’d declared. “Some of these accounts are new ones with a huge upside. Do we really want to cut them off? And Westmid—sure, it’s been tough going with them for the past few years, but things are starting to improve. And look at our history together: 63 years! They’ve been hugely profitable for us in good times, and they’ve stuck with us when lots of other customers have turned to China. We can’t just cut them off based on a cost-accounting report.”

Tommy had tried to make his case, but in the face of Jane’s impassioned stand, the committee couldn’t agree on what to do about the unprofitable customers.

Later that day, Jane knocked on Tommy’s office door. “I’m serious about Westmid,” she said. “They’re right here in Birmingham. I drive past their yard on my way to work. They’ve been great partners. Dropping them is unthinkable.”

Hardly an objective observer, Jane had been instrumental in creating that “great” partnership, by encouraging Egan to meet Westmid’s requests for customized products and services, special allowances, and discounts. The larger Egan’s sales to West-

mid, the bigger Jane's monthly commission, to say nothing of the annual bonuses and award trips for the salespeople with the largest accounts.

Tommy had to restrain himself from congratulating Jane for transforming one of Egan's oldest customers into one of its most unprofitable. Instead, he said, "Our aim should not be to sell as many products as humanly possible to anyone who wants to buy. It should be to win in every one of our chosen markets. I, too, have a warm spot in my heart for Westmid—but the account is a laggard."

He told Jane that he had e-mailed Hammond about the committee's failure to reach consensus and that the CEO had pointedly asked for his recommendation regarding the worst-performing customers, such as Westmid. "I need to have an answer when he returns next week," Tommy said.

"Then come to my meeting at Westmid tomorrow," Jane offered. "You can't analyze everything from behind a desk. Due diligence happens in the field, too."

Tommy reluctantly agreed.

The Intangibles

"We don't need tea," Tommy said, waving away the tray. He didn't like Steve's overly chummy demeanor. Customers weren't supposed to know about the rationalization initiative yet, but he suspected that Jane had let the cat out of the bag.

Steve switched to a look of sincerity as he sat down. "We *truly* value our relationship with Egan," he began.

"I know you do," Tommy said. In truth, he felt a bit sorry for Steve. It wasn't his fault that Egan had developed a bad habit of providing Westmid with one-offs and custom work at a fraction of the real cost and of rush-delivering products in half-empty trucks just to hit Westmid's deadlines.

Jane chimed in: "And we value our relationship with Westmid." Tommy shot her a glance, but she continued.

"Steve, tell Tommy about the Sunderland project."

"Yes, right," Steve said, as if remembering lines from a script. "We're in negotiations to build a development of attached homes near the A19."

"And what about that industry conference last month?" Jane prompted.

"Yes, the conference. In London. Well, lots of talk about Chinese suppliers there. Impressive group, actually. Lots of buzz about them. But our CEO gave the keynote, focusing on the benefits of our relationships with local suppliers. He's passionate about supporting UK businesses, you know, and the press ate it up."

"We so often overlook the intangibles that we get from our loyal customers," Jane said. "The showrooms, too." She picked up a glossy booklet from Steve's desk and handed it to Tommy. He flipped through it, glancing at the photos of Westmid's new chain of decorator showrooms at high-end sites around London. She pointed to a picture. "Our doors," she said.

"This is a small part of Westmid's business now," she went on, "but it's bound to grow once the economy picks up. Our products *have* to be in these showrooms. Am I right?" This time Steve refrained

from speaking, because the question was clearly aimed at Tommy.

The only sound in Steve's office was that of Tommy turning the heavy pages. The booklet showed many images of Egan's doors—beautiful, top-of-the-line, thermally insulating products with fan lights and other expensive features. He looked at Jane. Her point was well taken: Westmid's showrooms were indeed an asset to Egan, one that Tommy hadn't considered.

Jane's smug expression said clearly, "Add this to your P&L, Tommy." ♥

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 **Robert S. Kaplan**, the Baker Foundation Professor at Harvard Business School, has written many HBR articles, including "Time-Driven Activity-Based Costing," coauthored with Steven R. Anderson (November 2004).

Should Tommy recommend that Egan drop the Westmid account?

WHY THERE ARE NO MORE CLASSICS



"I'll shoot you an e-mail."