Strategic Profitability Management

An Opportunity for Finance Departments

Research Perspective

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Making Profitability Management Strategic

One of the more pressing issues that companies will face over the next several years is managing profitability. Contending as they are with challenging economic conditions, increasingly global markets and the impact of volatile prices and exchange rates, they must manage profitability strategically. Yet Ventana Research finds that few companies have a reliable way to achieve the widest margins consistent with other strategic objectives, largely because no one person or organization is responsible for it.

To manage profitability effectively, a company must have a strategy and the ability to execute it. It must have the means to consistently determine its true costs accurately, set objectives based on this information and then quickly identify and address the causes of underperformance and outperformance. It needs the agility to optimize its response to competitive moves and changes in the economic outlook. It must be able to rapidly perform and act on what-if analyses. Where should the responsibility for this lie? Ventana Research believes finance departments are uniquely well suited to manage profitability.

Finance departments now must play a more active and strategic role in the performance of their company's operations.

Finance departments have a new mandate. They have spent the past two decades becoming more efficient by automating processes. They now must focus on becoming more effective. They must play a more active and strategic role in the performance of their company's operations, adding value by applying their analytic skills to the profitability of the business while spending less time on tactical "bean counting" functions.

Focusing on profitability management, which can be an important differentiator of performance, should be the first step. Finance departments typically are strong in number-oriented and analytical skills. Most already drive a company's budgeting, planning and periodic review process. Managing profitability must be made to be an integral part of this cycle. As well, finance departments rarely have a vested interest and therefore can be neutral arbiters in a process that often requires balancing the needs and priorities of individual business units against the strategic objectives of the company.

The Need for Profitability Management

A corporation usually has a strategy and almost always has profit objectives, but the two may not be well aligned, with reason. There are challenges to achieving alignment. For example, our research shows that just one-third (33%) of companies track customer profitability regularly.[1] While almost all

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[1] Ventana Research, *Finance Analytics Benchmark Research: Benchmarking the Analysis of Data To Gain Business Insight*

companies have a strategy, only 25 percent of non-executive employees say they have a very good understanding of the objectives associated with their strategy.[2] The term "profitability management" itself can be misunderstood since companies have multiple ways of managing profitability. Individual executives and managers have financial targets and devise methods to achieve them. Individual departments and business units focus on, for instance, product profitability or channel profitability or customer profitability, but few companies have a process for systematically managing profitability across the business using a consistent analytical framework.

Most corporations attempt to achieve their profit objectives by maximizing their revenue and minimizing costs. But these alone do not constitute profitability management because they do not guide the organization to optimize profits in concert with its strategic objectives. Although most companies use some approach to cost analysis to understand product and customer profitability, few do it properly since they use accounting, not economic, measures of cost. Only about one-third (32%) of organizations have profit optimization capabilities in the software they use to support pricing decisions.[3] And individual decisions about pricing, promotions and inventive compensation commonly are focused solely on revenue impacts or are based on margin assumptions that are ad hoc, too limited or outdated. Or decisions are made that help one business unit this quarter but drive higher costs in others today or in the future.

Profitability management is a more rational approach that uses techniques for optimizing returns to meet strategic, corporate-wide objectives.

Focusing sales efforts merely to achieve the maximum volume or highest margin may not pay off in the long run. Simply avoiding costs can be counterproductive because companies must invest in new products, market position or production technology. In some cases, for example, it may be necessary to sacrifice short-term margins to generate additional sales volume to gain a longer-term cost advantage. Or it may take the form of a customer profitability initiative that systematically unbundles services and other components of an offer and charges all but the best customers for these add-on items.

It is critical that managers be able to understand a business's real economic costs so they are able to make informed decisions about (for instance) sourcing, substitutions, pricing and logistics. Today, these decisions must be made quickly because conditions are constantly churning. Understanding costs is important in two regards: for managing day-to-day decisions as well as supporting effectively strategic planning and long-range decision-making.

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[2] Ventana Research, *Financial Performance Management for the 21st Century Benchmark Research: A CFO's Agenda for Using IT to Align Strategy and Execution*

[3] Ventana Research, *Sales Forecasting and Demand Planning Benchmark Research: Setting the Agenda for Improving Core Processes*

Profitability management is a more rational approach that uses one or more techniques for optimizing (not just maximizing) returns to meet strategic, corporate-wide (not department or functional) objectives. By optimizing we mean balancing the top line, bottom line and strategic objectives.

Finance departments are uniquely qualified to lead the effort to optimize profitability because of their neutrality, numbers orientation and analytical abilities. However, as finance departments move to implement profitability management they need to recognize the challenges they may face. They must have a clear executive mandate and the political skills and support to be able to enforce rational choices in the face of entrenched interests. They must demonstrate an in-depth understanding of the various operations of the business and how to best address their needs. They must understand the limitations of viewing the business using only accounting data and traditional finance analytics. And they must have and use the right tools to support their profitability mandate.

Managing Profitability More Effectively

Having a profitability strategy, a process for applying it and an organizational structure to support it are prerequisites, but to implement and manage it a company also must use the right approaches and tools:

To implement and manage a profitability strategy a company must use the right approaches and tools.

Analytics: To optimize profitability, companies must have analytic tools to enable them to know the true cost of products and services in this rapidly changing economy. This may include today's more streamlined activity-based costing (ABC) tools, which can identify the true profitability of products, customers and even individual transactions better than traditional cost accounting. Many companies rely on desktop spreadsheets for costing and profitability analysis. Although it's easy to prototype even sophisticated models with spreadsheets, they are hard to change, error-prone and therefore difficult and time-consuming to use, especially when multiple data sets must be updated. Spreadsheets can prevent finance departments from achieving the agility necessary to manage profitability well, so more effective alternatives should be sought.

Planning and Review: The planning process establishes the objectives that align individual actions to the company's strategy. Planning software must enable business units to work collaboratively to resolve trade-offs and explore different possible approaches using shared scenarios and universal assumptions (such as commodity prices, labor rates and transportation costs). The software must support agile operations because companies will need to review and assess results, determine what changes to the plan are required and modify the plan accordingly. Contingency (what-if) planning should be a regularly scheduled activity to explore the impacts of scenarios so that if or when they occur, executives and managers will be able to

respond in a coordinated fashion. Dedicated planning software supports these activities well; spreadsheets do not.

Reporting: The right reporting tools enable monitoring of profitability and results vs. objectives, deliver alerts when thresholds have been exceeded and can be used to work interactively with data to explore underlying factors. Dashboards can help managers and executives quickly understand the meaning of complex data sets and focus their attention on the metrics that are key to optimizing profitability. Reporting also should allow users to view their results relative to key performance measures. Properly structured scorecards can guide managers in deciding among the inevitable trade-offs that have to be made as they try to optimize profitability.

Data: Our research[4] consistently shows that data availability is a key issue for corporations – indeed, the larger the organization, the bigger the problem. Thus an initiative focusing on managing profitability strategically must include a joint finance and IT team to identify and address any data availability issues that would prevent its successful implementation, compromise the accuracy of the analyses performed or delay decision-making.

The Right Next Steps

Companies must develop a focused, consistent process for managing profitability that incorporates at least three essential elements: a clear strategy, analytics that provide the insights to accurately assess profitability and guide decision-making, and the information technology to support profitability analysis, planning and execution. This must be done at a corporate or unified business unit level rather than in departmental silos because the objective is to balance the trade-offs required of functional groups. Information technology is a key component in the success of profitability optimization initiatives because it delivers to executives and managers important insights into what drives real (rather than just accounting) costs and provides analytics that will enable them to quickly determine the best ways to optimize trade-offs.

Ventana Research believes the finance department is uniquely well suited to take ownership of strategic profitability management efforts.

Ventana Research believes the finance department is uniquely well suited to take ownership of strategic profitability management efforts because it is a neutral party, it already has access to much of the data necessary for such a program, and it likely has people trained in analytics and business analysis.

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[4] Ventana Research, *Business Analytics Benchmark Research: Benchmarking the Analysis of Data to Gain Insight*; *Data Governance Benchmark Research: Benchmarking the Maturity and Usage of Data Governance Processes and Technology*; *ERP Innovation Benchmark Research*; *Information Management Benchmark Research: Actions, Intentions, Perceptions and Trends in Information*

Implementing a strategic profitability initiative need not be overly expensive or time-consuming. Typically, companies already have many of the necessary information technology components. What they need is recognition that profitability management will enhance a company's strategic position and a concerted effort to create the processes and related systems for systematically managing profitability on a daily basis using a consistent analytical framework. In this way, they can achieve the widest margins consistent with their key strategic objectives.

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