Viewpoint

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Implement Active Profitability Management

Managing profitability effectively is especially important in today's constrained pricing environment. Shifts in market structures, including globalization and better-informed customers, have made it difficult to raise prices. So companies must have a clear picture of their costs and cost drivers to be able to improve efficiency, eliminate unnecessary costs and manage their pricing more intelligently. However, our benchmark research on the Office of Finance finds that relatively few companies actively manage profitability through the use of analytics. Just 32 percent of participants said they apply analytics to manage product profitability, and only 29 percent said that about customer profitability. Determining the cost to serve specific customers is essential to profitability, but our research shows that only 6 percent of companies perform this type of analysis.

Active profitability management is a rigorous approach to increasing the profitability of a business when considered by, for instance, customer, product, channel or region. Using active profitability management makes it feasible to manage costs in a more sophisticated way. For example, it identifies cost drivers so that managers can develop strategies to avoid unnecessary spending. It also measures the cost to serve a customer, and it does so with sufficient accuracy and detail to enable the company to develop pricing frameworks and policies aligned to its customer and channel strategies. Over time, companies that achieve higher profitability compared to their peers should be able to consistently achieve above-average returns on assets relative to their industry.

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From a strategic standpoint, a company with above-average profitability is likely to have stronger cash flows that it can reinvest in the business. A company that has a complete and granular understanding of where it makes money is better able to allocate its capital investments and other resources to achieve its strategic objectives.

Our research finds three main reasons why companies do not actively manage profitability. One is that they lack data that is sufficiently accurate, appropriate, timely and reliable. Another is that they don't have a dedicated application that enables business users to conduct profitability analyses without involvement by their IT department. The third reason applies to companies that have issues with data quality or produce profitability analyses that aren't credible: They face resistance to profitability management initiatives from line-of-business people. We assert that addressing the first two problems will deal with the last.

Implementing active profitability management begins with addressing the data and software issues. Having immediate access to accurate, consistent and up-to-date data is essential. To this end, most companies would benefit from having software that automates the collection and storage of all the financial and operational data needed to actively manage profitability. They also need software that provides action-oriented frameworks in which to perform the analysis and automates profitability reporting.

Active profitability management is an approach companies should take to improve their profitability and competitiveness. Such an effort requires the right tools to implement a sustainable process that is efficient and credible. Senior finance executives are well placed to drive profitability management initiatives in their corporations. For those who want their department to play a more strategic role, more effective profitability management can be a great way to start or a valuable new initiative along that path.

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Robert Kugel is responsible for the Office of Finance and business research, focusing on the intersection of information technology with the finance organization and business. His research agenda includes the application of IT to finance and business process optimization, looking particularly at ERP and continuous accounting, financial performance management, predictive planning, price and revenue management, revenue and lease accounting and robotic finance.