Unlocking Profitability Potential in Turbulent Times and Beyond

A report prepared by CFO Research Services in collaboration with IBM, provider of IBM Cognos business intelligence (BI) and performance management solutions

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Contents

Executive summary

In April 2009, CFO Research Services (CRS) conducted a survey among 171 senior finance executives in the United States on their uses of profitability analysis. The survey was completed while the outlook for the U.S. economy, and indeed for the global economy, was anything but certain. In turbulent times, the ranges of variability in projected outcomes tend to increase; and at the time that this survey was conducted, variability seemed to be the dominant characteristic of many forecasting and planning activities. Companies found that recent history was no longer a very good guide for future projections. In addition, companies' expectations for top-line growth shrank considerably in the recession, and finance executives found themselves focusing more on profitability than on growth. Given the pace of change in global markets, this concern with measuring profitability in the face of increasing variability may well continue even after the expected economic recovery.

In this environment, we hypothesized that the need for a forward-looking understanding of profitability and its drivers would become more acute than ever. We carried out this research program to test our hypothesis. The survey produced several key findings:

- Most companies are using a combination of several different profitability metrics to make decisions, at both the corporate and business unit levels. They primarily use broader measures, such as overall corporate profitability, line of business profitability, and profitability by organizational unit or function. Granular measures of profitability, such as by location or employee, are used more selectively.

- The finance executives in this survey agree on the importance of having a forward-looking view of profitability, but relatively few say that their profitability analysis is more than simply adequate. Only about half of the respondents say that business unit management has a good understanding of the use of profitability data or has ready access to it for decision making.

- A relatively small set of respondents report that their companies employ the highest level of technology in analyzing profitability, while many companies still rely primarily on manual processes, such as manipulation of multiple spreadsheets. The finance executives from companies they characterize as highly automated are much more likely to report that their companies are better able to use profitability analysis effectively. Survey results reveal that these executives are more likely to agree that their business unit managers have ready access to, and understand the use of, profitability data, and they conduct profitability analysis more regularly. They also see much stronger collaboration than other respondents between finance and the different parts of their organizations in reporting, analyzing, and using profitability data.

ABOUT THIS REPORT

In April 2009, CFO Research Services launched a research program on the use of profitability analysis for strategy setting, business decision making, and performance management. We distributed a survey among senior finance executives in the United States, and received a total of 171 responses.

Survey respondents hold positions with the following titles:

Chief financial officer	38%
Director of finance	18%
VP of finance	15%
Controller	13%
EVP or SVP of finance	5%
Treasurer	2%
Other	9%

Respondents come from companies of different sizes in terms of annual revenue:

$100 million–$500 million	43%
$500 million–$1 billion	16%
$1 billion–$5 billion	26%
$5 billion+	15%

Respondents represent a broad cross-section of industries:

Manufacturing	23%
Consumer goods (retail, wholesale)	13%
Business services	11%
Financial services/Insurance	11%
Health care	11%
High technology (software/hardware, systems, telecommunications, etc.)	5%
Public sector (education, government, non-profit, etc.)	5%
Life sciences	2%
Other	21%

Note: Percentages may not total 100%, due to rounding.

Many companies still rely primarily on manual processes for analyzing profitability.

A preponderance of high-level profitability measures

In the past year, CFO Research Services (CRS) has documented a shift in companies' focus from managing revenue growth to managing profitability. This shift tracks closely with growing economic uncertainty and with the current recession: As top-line growth prospects fade, finance executives strive to help their companies meet profitability targets by working to manage the bottom line.

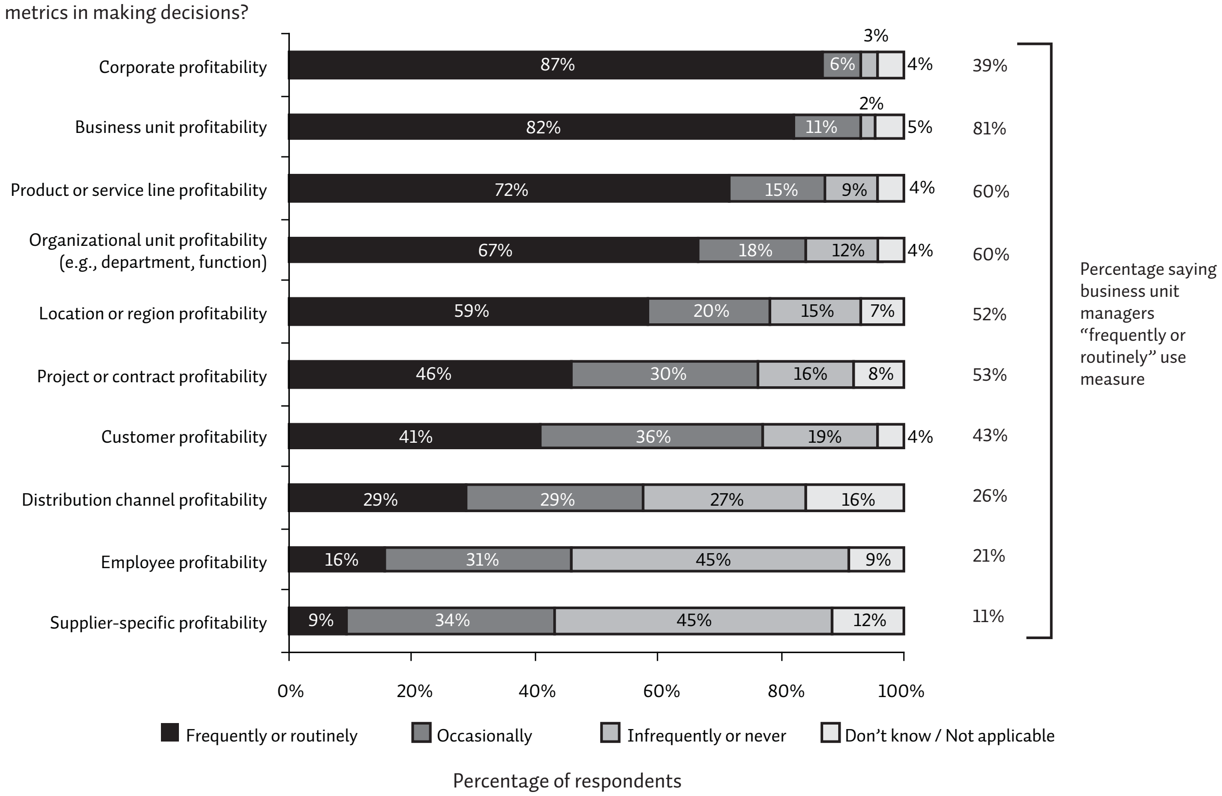
Recent CRS studies show that companies are leaving no stone unturned as they work to protect, and even improve, their bottom line: reducing travel and other G&A expenses; ramping up initiatives to improve operating performance; renegotiating supplier agreements; and reducing workforces to better match production with lower demand. This study confirms the increased focus on profitability, with two-thirds of respondents saying that economic uncertainty has caused them to review and adjust their profitability measures more often than previously.

In this study, we examine how companies are using profitability data in these difficult times, not just to uncover savings in the short term, but as part of their forward-looking efforts to make good business decisions. We surveyed finance executives in the United States on the level of detail available for profitability data, who in their companies uses that data, and how it is used.

We found that, at respondents' companies, both corporate management and business unit management are most likely to use a combination of relatively broad, high-level measures of profitability to support decision making. More detailed or granular measures of profitability are used less frequently. Corporate management and business unit management exhibit few differences in the types of profitability metrics they use most frequently. (See Figure 1.) In fact, at most of the companies represented in the survey, business unit management uses the same measures of profitability in their decision making as does their corporate management. Business units largely seem to be on the same page as corporate management in their focus on the profitability measures that the company considers most relevant.

FIGURE 1. THE MAJORITY OF COMPANIES RELY ON RELATIVELY HIGH-LEVEL MEASURES OF PROFITABILITY.

How common is it for corporate management at your company to use the following types of profitability metrics in making decisions?



Note: Percentages may not total 100% due to rounding.

According to 87% of survey respondents, corporate management frequently or routinely uses overall corporate profitability in making decisions. A large majority of respondents (82%) also say that their corporate management frequently or routinely uses measures of profitability at the business unit level. Smaller majorities of respondents report that their corporate management frequently uses product or service line profitability measures (72%) and measures of profitability by organizational unit, e.g., department or function (67%). Almost all of the companies represented in the survey also routinely use two or more of these high-level measures, not relying exclusively on any one metric.

However, aside from these broad measures, fewer finance executives in the survey report that their companies' management routinely employs measures of other elements of profitability in decision making. Fifty-nine percent of respondents say their corporate management routinely uses profitability measures for different locations or regions, and even fewer (41%) routinely use customer profitability measures in decision making. Metrics such as distribution channel profitability (29%), employee profitability (16%), and supplier profitability (9%) are used by corporate management even less frequently.

> Some companies simply are doing a better job of analyzing profitability and using the results effectively.

These results largely hold true for business unit management as well as for corporate management. In a separate question, we asked finance executives how frequently their business unit managers (as opposed to corporate management) used the different profitability measures. Here again, we find that companies primarily rely on higher-level measures. Eighty-one percent of respondents say that their company's business unit management frequently or routinely uses business unit profitability in making decisions, and 60% say that business unit management uses product or service line profitability frequently or routinely. Only about half of the respondents (52%) report that business unit managers routinely employ profitability measures for regions or locations, and less than half (43%) say that business unit management routinely uses customer profitability. As with corporate management, very few business unit managers routinely use distribution channel profitability (26%), employee profitability (21%), or supplier-specific profitability (11%).

The largest disparity between corporate management and business unit management is in their use of corporate profitability measures. While 87% of respondents say that corporate management uses corporate profitability measures frequently or routinely, less than half that many (39%) say that business unit management routinely considers corporate profitability in their decision making.

Room for improvement in profitability analysis

Many respondents see room for improvement in their companies' processes and practices for analyzing profitability. More than half of the finance executives in the survey rate different elements of profitability analysis at their company as simply adequate, at best, or in need of improvement. (See Figure 2.) Areas where respondents indicate they can improve include the frequency of profitability reviews; the ability of business users to employ profitability data effectively; and the use of profitability data to provide a forward-looking view of performance and to set strategy. While, in a separate question, 87% of respondents say their company ties forward-looking profitability modeling to planning, budgeting, and forecasting processes, only 22% rate their company's forward-looking view of profitability as more than adequate.

In nearly every case, finance executives who see a need for improvement in their profitability analysis (i.e., give an element a rating of 1 or 2) outnumber both those who say their processes and practices are adequate (a rating of 3) and those who say they are doing better than adequate (a rating of 4 or 5). No single area is isolated as in need of improvement: In general, respondents report that their companies either are good in all aspects of profitability analysis, or that they need improvement in all aspects. Some companies simply are doing a better job of analyzing profitability and using the results effectively.

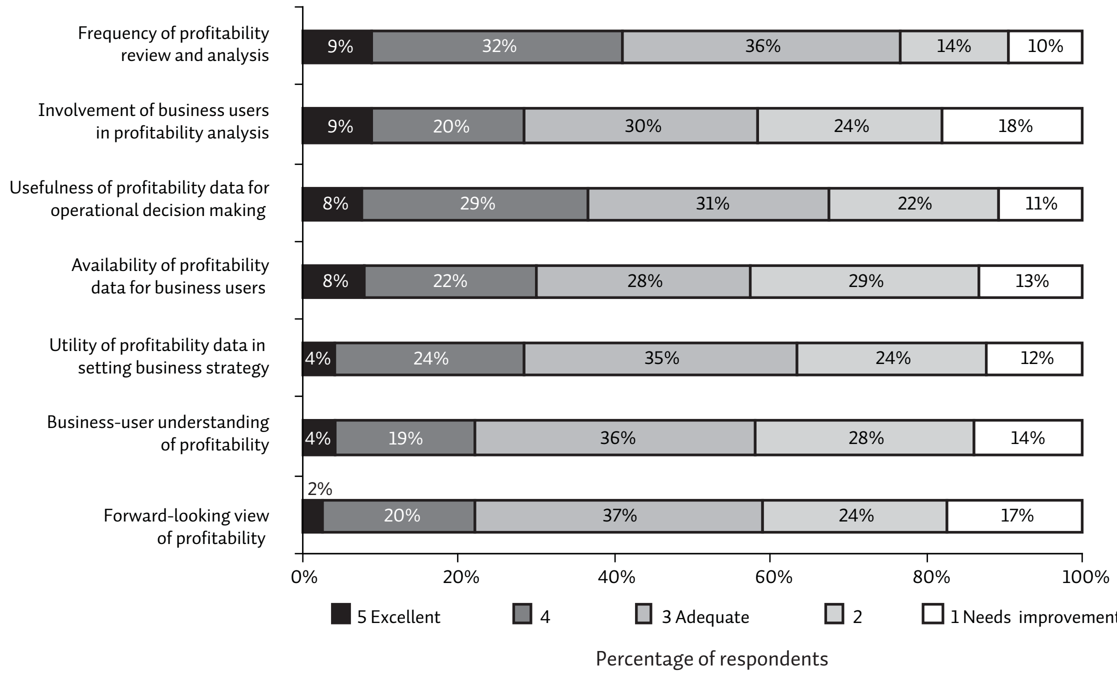
Using automation to unlock profitability analysis

The finance executives who express higher satisfaction with their profitability analyses tend to come from companies that employ higher levels of automation to support their processes. We asked respondents to characterize their companies' process for collecting and analyzing profitability data as one of the following:

- Highly automated (e.g., technology is widely used for collecting and analyzing profitability data; dynamic or ubiquitous access to granular profitability data)

FIGURE 2. MORE RESPONDENTS SEE ROOM FOR IMPROVEMENT IN THEIR PROCESSES FOR MANAGING PROFITABILITY THAN SAY THEY ARE DOING A GOOD JOB.

On a scale of 1 to 5, with 1 being "needs improvement" and 5 being "excellent," how would you rate your company's process for managing profitability along the following dimensions?



Note: Percentages may not total 100% due to rounding.

- Automated for basic functionality (e.g., technology used to aggregate costs, define metrics, and generate management reports, but little or no real-time access to profitability data for end users)

- Primarily manual (e.g., widespread use of spreadsheets; manual inputs; few, if any, enterprise software applications)

Only 16% of respondents characterize their companies as highly automated, while almost half (48%) of the respondents say they are automated for basic functionality and 36% still use primarily manual processes.

Respondents from highly automated companies uniformly give higher ratings to their processes for managing profitability than do respondents from other companies. Especially when compared with primarily manual companies, responses from finance executives at highly automated companies reveal that they have more confidence in their processes for analyzing profitability, are able to conduct analyses more frequently, and work better with line-of-business managers in employing a wider range of detailed profitability data.

Much higher percentages of respondents from highly automated companies rate the different elements of their companies' profitability analysis processes (listed in Figure 2) highly, that is, a 4 or 5 on a 5-point scale. Many of the respondents from primarily manual companies rate those elements as less than adequate (i.e., a 1 or 2). In fact, out of 61 respondents from primarily manual companies, only three respondents rate any individual element as "excellent." Respondents at companies that still rely on spreadsheets and other manual processes lack confidence in their companies' ability to use profitability analysis effectively.

Better access to data. Respondents from highly automated companies indicate that their business unit managers have much better access to profitability data than do their counterparts at primarily manual companies. Two-thirds of respondents from highly automated companies (67%) rate the availability of profitability data for business users highly (4 or 5); in contrast, nearly two-thirds of those from primarily manual companies (64%) rate data availability as less than adequate (1 or 2). And, while 37% of respondents from highly automated companies say that the availability of profitability data for business users is excellent (the highest possible rating), only a single respondent from a primarily manual company does so.

In response to a different question, three-quarters (75%) of those from highly automated companies agree that business unit managers at their companies have ready access to profitability metrics; only 35% from primarily manual companies do so. These results suggest that companies that have automated their profitability analysis simply are better able to get the results of that analysis into the hands of their business managers.

Better use of data. Once managers have the profitability data, those at highly automated companies are also more likely to use it effectively in managing the business. About three-quarters of the respondents from highly automated companies (78%) rate the usefulness of their profitability data for operational decision making as a 4 or 5, with 30% rating it as a 5 ("excellent"). Only 12% of respondents from primarily manual companies—a 66-point difference—agree that the usefulness of profitability data is any better than adequate, and no respondents from any of the primarily manual companies rate it as excellent.

When asked whether they agreed or disagreed with the statement that business unit managers at their company understood the impact of their operating decisions on profitability, 71% of respondents from highly automated companies agree, compared with 39% from primarily manual companies. More than half of the respondents from primarily manual companies also give low ratings of 1 or 2 to business-user understanding of profitability (55%) and to involvement of business users in profitability analysis (58%).

A more detailed understanding of profitability. In addition, nearly all (96%) of the respondents from highly automated companies agree with the statement that their company's profitability data allows them to identify profitable and unprofitable products or services; only half (49%) of respondents from primarily manual companies make the same claim. In fact, at both the corporate and the business unit levels, finance executives from highly automated companies report that management routinely uses more granular measures of profitability at higher rates than do those from primarily manual companies. (See Tables 1 and 2.) This segmented view of profitability—by product or service line, by location, by customer, or by distribution channel—can be critical for projecting both operating and financial performance and for effectively allocating resources to optimize profitability.

Greater collaboration among the users of profitability data. The effective application of technology can also encourage better collaboration among managers. Respondents from highly automated companies report much stronger collaboration in reporting, analyzing, and using profitability data than do their counterparts from primarily manual companies. (See Table 3.) This holds true for collaboration among business units themselves as well as for collaboration between finance and the business units.

Frequent and regular reviews of profitability. Part of the reason why managers at highly automated companies make wider and better use of profitability data may simply be due to their ability to conduct profitability analyses more easily using automation. Three-quarters of respondents from highly automated companies report that they conduct profitability analysis either monthly (61%) or weekly (14%). Less than half of the respondents from primarily manual companies say they conduct profitability analysis that often (39% monthly and 5%

TABLE 1. CORPORATE MANAGEMENT "FREQUENT OR ROUTINE" USE OF GRANULAR PROFITABILITY MEASURES

	Highly automated companies	Primarily manual companies	Difference
Product or service line profitability	89%	68%	+21
Location or region profitability	71%	54%	+17
Customer profitability	54%	31%	+23
Distribution channel profitability	50%	20%	+30

TABLE 2. BUSINESS UNIT MANAGEMENT "FREQUENT OR ROUTINE" USE OF GRANULAR PROFITABILITY MEASURES

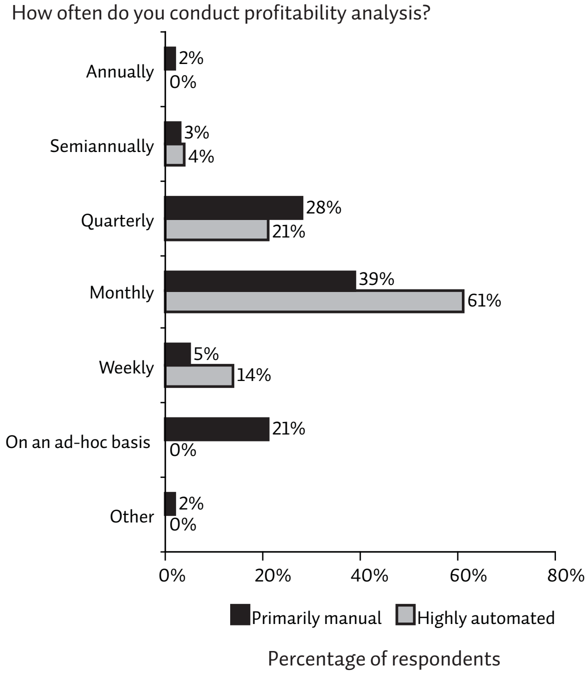
	Highly automated companies	Primarily manual companies	Difference
Product or service line profitability	75%	56%	+19
Location or region profitability	75%	41%	+34
Customer profitability	50%	37%	+13
Distribution channel profitability	43%	16%	+27

TABLE 3. TOP RATINGS FOR COLLABORATION (RATING OF 4 OR 5, WHERE 5 = "STRONG COLLABORATION")

	Highly automated companies	Primarily manual companies	Difference
Between business units and finance	72%	38%	+34
Between finance and sales and marketing	68%	29%	+39
Among business units	40%	12%	+28

FIGURE 3. HIGHLY AUTOMATED COMPANIES ARE MUCH MORE LIKELY TO CONDUCT PROFITABILITY ANALYSIS ON A MORE FREQUENT SCHEDULE, WHICH CAN INCREASE THE UTILITY OF THE RESULTS IN BUSINESS PLANNING.

How often do you conduct profitability analysis?



weekly). (See Figure 3.) Relying on manual processes for collecting and analyzing profitability data can be time-consuming and inefficient, limiting the frequency—and therefore the timeliness and utility—of the analysis.

Profitability analysis also appears to be "built into" formal processes more at highly automated companies. A much higher percentage of respondents from highly automated companies say that their companies have formal business processes for analyzing profitability (89% vs. 51% of respondents from primarily manual companies). And none of the respondents from highly automated companies say they only analyze profitability on an ad-hoc basis, suggesting that all of these companies review profitability on a regular basis; 21% of those from primarily manual companies report that their analyses are ad hoc.

A forward-looking view of profitability

It seems apparent that managers at companies still relying on manual data collection and analysis processes are not as well equipped to make use of a rich set of data on their business' profitability. Automating processes can make the results of profitability analysis more readily accessible to more people, including business unit managers. When done right, automation can streamline the collection of data, help management to focus on key business drivers, free up critical resources for value-added activities such as forecasting and analysis, and distribute key results to a wider user community.

Resource planning and strategic decision making grow out of performance projections; with the economic outlook in a state of volatility, the ability to evaluate the profitability impacts of specific decisions and actions is even more critical, as most companies have less room for error. But the same economic uncertainty that makes forward-looking profitability analysis more critical also makes it more challenging. Those companies that can develop a more detailed view of the drivers of profitability will be better positioned to make the decisions that can carry them through uncertain times. In this survey, the companies that make greater use of automated systems for generating insights into profitability appear to be better positioned to take full advantage of those insights to guide their businesses.

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Sponsor's Perspective

A new and compelling approach to profitability analysis

These are indeed challenging economic times, and more than ever before finance organizations are under increasing pressure to manage risk, drive cash flow, contain and reduce costs, and improve profits. At the same time that finance organizations need short-term lifelines to respond to a slowing global economy and limited access to the capital markets, they also need to transform critical business processes so that when the economy recovers they are in a position of sustainable competitive advantage.

As organizations navigate troubled times and prepare for the "new economic reality" that rewards smarter and faster response to business conditions, better visibility into what truly drives profitability is critical. Profitability analysis (also sometimes referred to as financial analytics) is a relatively new cross-enterprise discipline that unlocks profit potential to drive performance. Profitability analysis helps enterprise functions (e.g., sales, marketing, operations, engineering, etc.)—in the context of their day-to-day strategic and tactical business decisions—answer "profit-focused" questions across multiple dimensions, such as: Who are my profitable customers? What are my profitable products? Which are my profitable sales channels?

In this way, profitability analysis is evolving from merely a reporting exercise driven by management accounting to one that provides the insights needed to optimize the business. By applying these new business practices and tools (including automation) in profitability analysis, enterprises can deploy limited resources in pursuit of the most profitable opportunities. This transformational shift is compelling finance organizations to move beyond the complexity of costing and to focus on an approach that helps the business. It also seamlessly integrates with the existing performance management processes within the enterprise, such as planning and forecasting, strategy management and scorecarding, consolidation and control, etc.

IBM, as part of its ongoing commitment to the finance organization to help drive better performance, has collaborated with CFO Research Services to bring out this report on profitability analysis. Some of the newer and strategic approaches to profitability analysis that this report has highlighted reinforce the feedback IBM receives from its customers.

This report (based on responses from CFOs surveyed across a variety of industries and sizes) underscores the relevance and importance of profitability analysis during turbulent times. In particular, it points toward:

- The importance of assessing the right profitability measures to drive performance
- The drive to improve profitability analysis even among forward-looking organizations
- The critical need to undertake profitability analysis more frequently
- The usefulness of automation in differentiating an organization's ability to conduct profitability analysis effectively
- The need for better access to and use of profitability information
- The requirement to collaborate effectively to develop and analyze meaningful and accurate profitability information

In conclusion, now is the time for the finance organization to step up to the challenges and become a strategic business partner in the deployment of profitability analysis across the enterprise. This requires a fundamental shift—in terms of both vision and execution. Tomorrow's winners will be the ones that are not content simply to survive this economic onslaught, but work to emerge nimble enough to thrive. Profitability analysis is critical in this context.

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