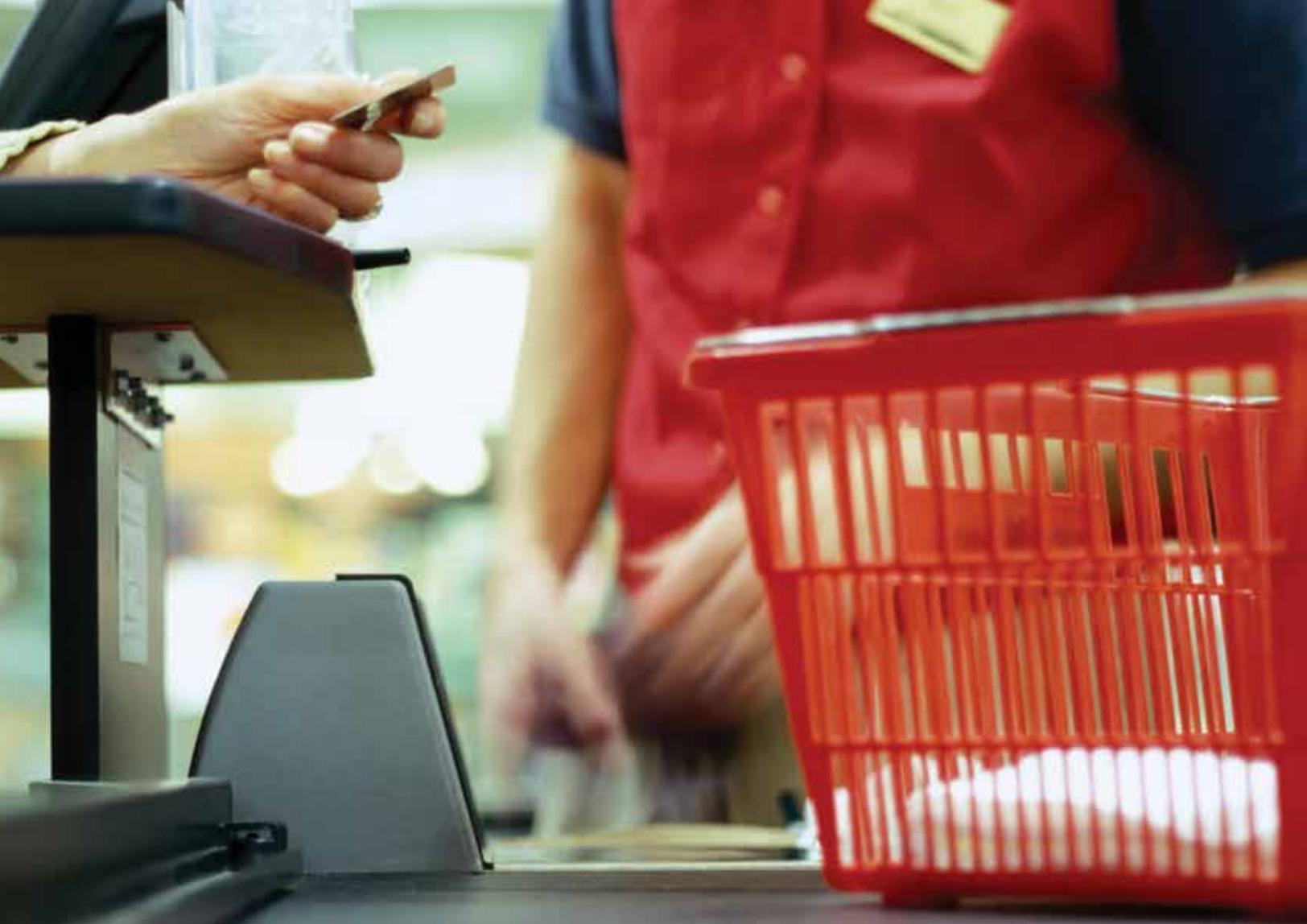


A close-up photograph of a person's hand holding a credit card over a shopping cart. The cart is filled with various groceries, including a clear plastic container of green leafy vegetables, a purple carton of milk, and a yellow carton of juice. The background is slightly blurred, showing other people in a grocery store setting.

High performance. Delivered.

Measuring the True Profitability of
Products, Services and Customers
From increased transparency comes
actionable insight



In today's highly competitive and volatile global marketplace, business leaders need rich and relevant information on the true profitability of the products and services they offer to customers. Yet for many, the apparently simple task of measuring profitability of offerings is buried in a morass of confusing and often arbitrary cost allocations. The solution is to adopt a structured, methodical approach to calculating profitability.

Most companies today struggle with identifying which of their offerings and which of their customers are the most profitable. They can measure revenue but not the profit associated with the product or client group – which means they make decisions about what to sell, in which markets, to which customers, and at what price based on partial or inaccurate information. They operate without a single version of the truth. Methods used to allocate large buckets of costs such as sales, advertising and customer service can be arbitrary and potentially inaccurate.

A crux of the problem is that current reporting structures are primarily designed for purposes other than measuring profitability such as meeting regulatory requirements; optimizing tax treatments; and supporting cost budgets for cost centers, R&D and other business units. Cost allocation models tend to be overly complicated as a result, and they do not reflect the true resource consumption in the value chain.

Companies have most of the information they need to measure and manage profitability, but it is scattered across multiple source systems and often, the business rules have yet to be established. They typically lack the methodology, the structures, and the analytics to consolidate the data and then calculate the true cost of the value chain. That means they may not answer basic questions such as “What is the cost of the processes we are performing?” or “What is the cost of the products we are delivering?”

A bottoms-up approach reflects a disciplined and systematic approach to this challenge. Data can be detangled, cleaned, and aggregated. Costs are allocated to cost elements and cost elements are assigned positions along the value chain. Business rules are established to roll up costs across the steps of the value chain and allocate them to products and customers in a transparent way.

Setting up this new structure is hard work; but once it is in place, companies may have a wellspring of data to support agile decision making. For strategic choices a company may be considering – such as a price, cost, volume, or product mix change – profitability analytics can help model:

- Required resources in the value chain
- Functional impact per cost center and staff, including the impact on any outsourced step in the value chain
- Impact of changes in input costs, product specifications, resource levels and productivity

Data crunching occurs at speeds that would have been unimaginable in recent past. Case in point: Every month a bank client calculates the profitability for each of the 56,000 customers in a critical segment across

1,000 products. The calculation cycle used to be 6 months— now it's down to 50 hours, with most of that time dedicated to data cleansing. The bank's ultimate goal is to complete this calculation in 20 hours, or a mere 2 business days.

With the analysis results in hand, the bank can trace costs based on actual transactions and no longer rely on allocations based on percentages. As a result, the distribution of costs throughout the organization (regardless of profit center or cost center structure) has become highly transparent. A portal of multidimensional reports can give executives the basis for discussions at both strategic and tactical levels (for examples of portal reports, see the sidebar “Actionable Decision Making”).

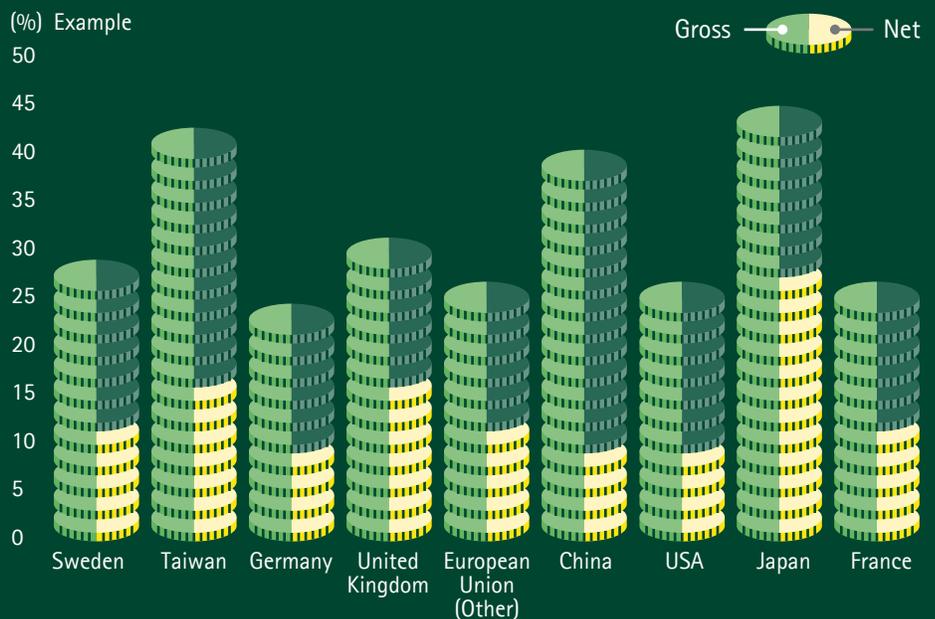
Once the system is set up, most of the heavy lifting is done. Executives can focus on analyzing results and making decisions, not gathering data.

Actionable Decision Making

Once executives have a detailed understanding of what drives costs in a company, they can figure out if their offerings are profitable, their resources are allocated to best advantage, and their products are priced and promoted to drive profitable growth. A differentiator now, such information will soon become table stakes, with business leaders drawing insights from multidimensional reports such as the examples shown here.

A European retailer wanted to increase its sourcing from China, given the high gross margin. Further analysis, however, showed the net margin was the lowest of any of the countries being considered. This insight resulted in a change in sourcing strategy.

Figure 1: Comparison of supplier gross and net margins based on their location

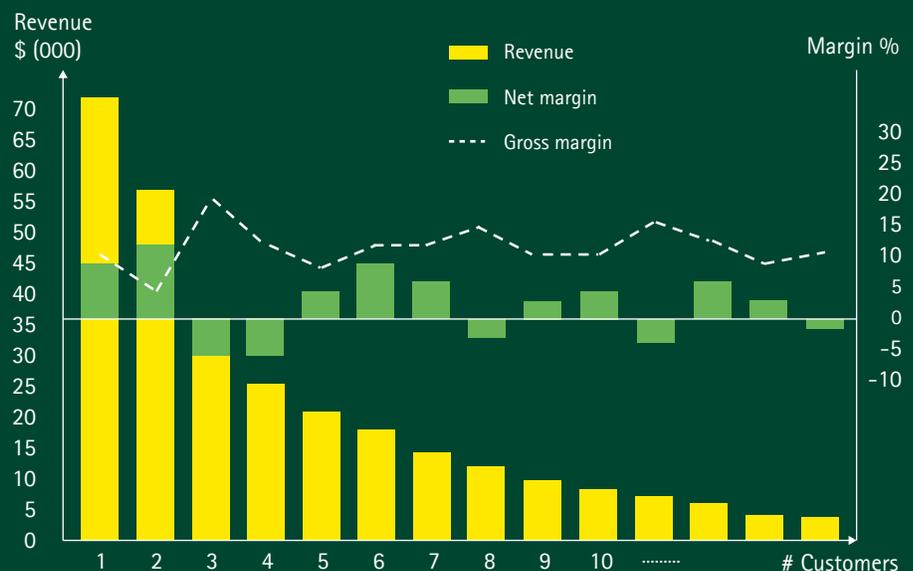


A decision support tool can help aggregate information from the customer relationship management system on:

- Customer income
- Net profitability
- Offerings the customer is using
- Customer billings by offering

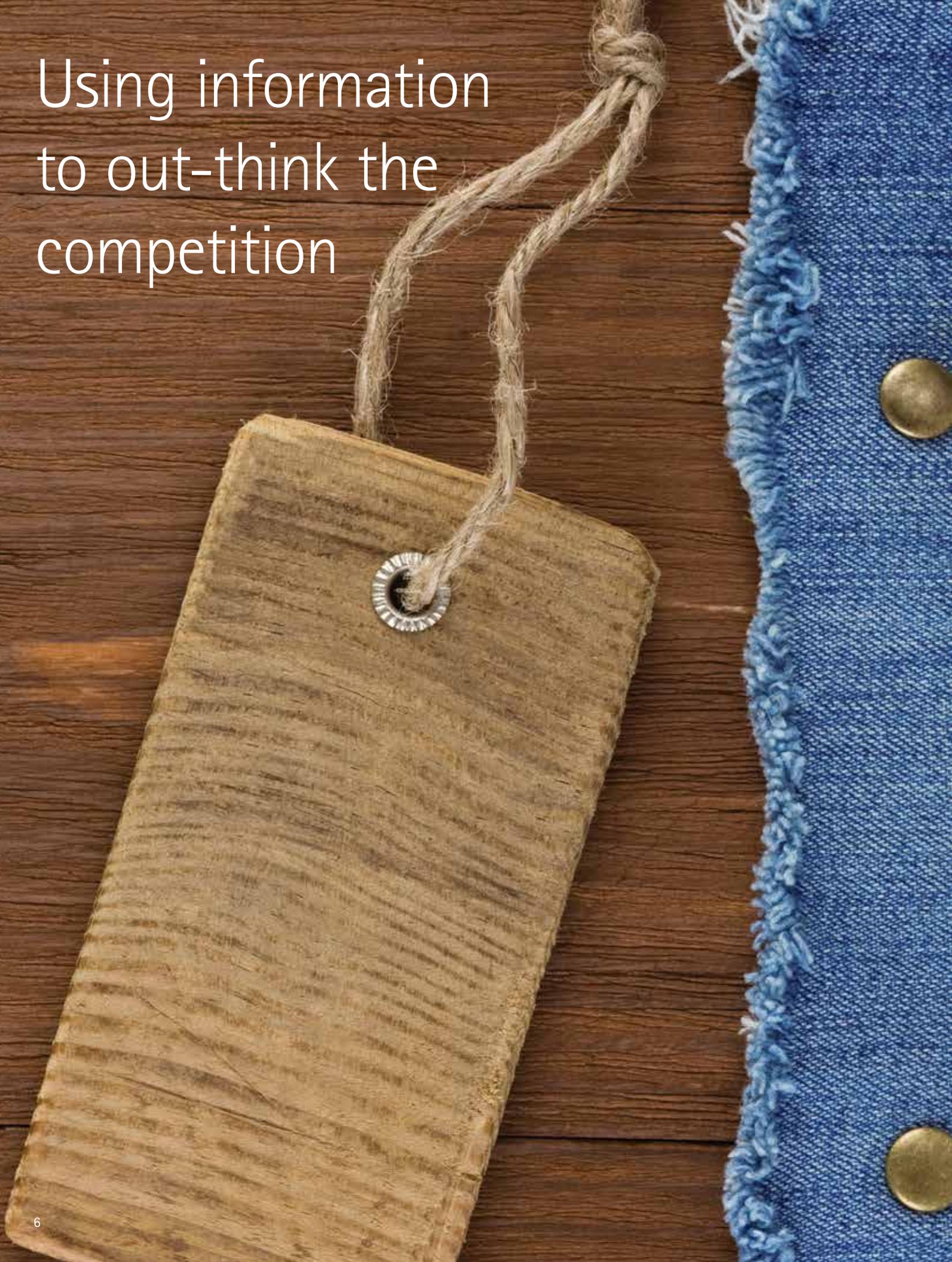
Based on that data, decision makers can examine net profitability contribution by customer segment or decompose those numbers down to the individual customer level.

Figure 2: Revenue, gross and net margin correlation by individual customers





Using information
to out-think the
competition



Whether a company is primarily focused on a cost-cutting agenda or looking at a growth agenda, profitability analytics can provide insights for driving that agenda forward. The “ah-ha” moment for business leaders occurs when they realize what they can do differently based on the data they now have. Three examples of better decisions – in product pricing and messaging, improving process efficiency, and targeting offerings to customer segments – illustrate that point.

Product profitability

A European electronics company is in the process of revamping its product pricing and promotion strategy. With a profitability analytics solution in place, the product manager was able to identify that two product categories produced the highest net profit for the company; further, three categories consumed rather than produced net profit.

Next, the product manager studied the portal report that decomposed costs down to the product code and showed the cost distribution pattern. For the first time, he could see where the costs associated with each product arose and could identify the lowest acceptable price for each product the company sells. Further, he could model the

effect on product profitability of changing the cost of processes associated with manufacturing, sourcing, and selling those products.

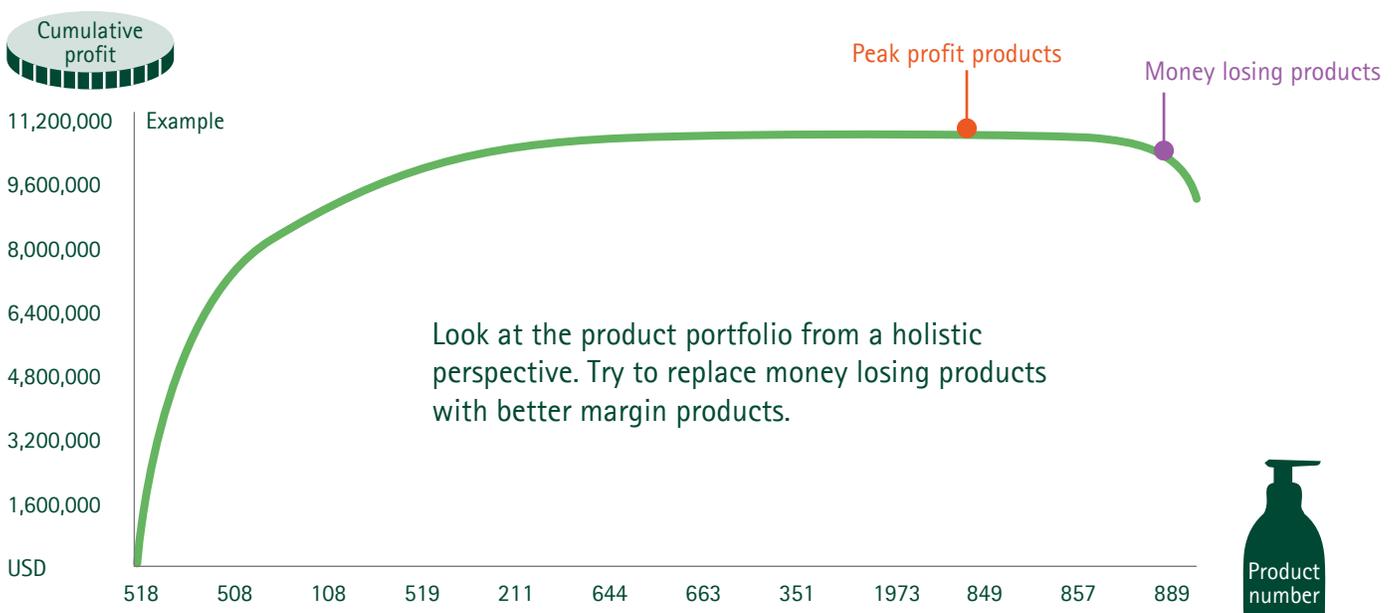
Based on product insights such as these, the electronics company:

- Changed the pricing structure and configuration of its product portfolio
- Identified which products to promote to which customers, with the goal of ensuring that “cash cow” products (with high net profitability) were promoted to all customers
- Revised its cross-sell and up-sell strategies
- Identified potentially important customer segments that had not been targeted for growth

The tipping point in this process occurred when the product and sales managers finalized sales strategies based on the products customers purchased. Their goal was to ensure that customers purchased “cash cows” as well as products that were complementary to the cash cows.

Aggregated profitability analysis such as that shown in Figure 3 helped convince both of them of an important strategic guideline. Customers that bought only complementary products were unprofitable. And customers that bought unprofitable products should be serviced differently from customers that bought promoted products.

Figure 3: Aggregated product profitability



Source: Accenture, analysis based upon a hypothetical example

Customer profitability

A \$5B consumer goods company has an ambitious growth agenda. Through its profitability reports, the company discovered that 20 percent of its customer base generated 80 percent of its profits, 15 percent generated 30 percent of the profits, while 50 percent produced zero profit, and 15 percent caused losses of 10 percent.

By modeling different business scenarios, the product and sales managers of the company learned that:

- Many high-revenue customers were purchasing unprofitable products. The level of revenue they produced hid the fact that the net margin on servicing them was low or nonexistent.
- If zero-margin customers could be made even a little more profitable, the company's profits would increase by 20-30 percent.

The managers strategized on ways to:

- Incent high-revenue customers to buy a more profitable mix of products and services.

- Ascertain why zero-profit customers were not buying more – and, if their behavior could not be changed, to identify ways to decrease these customers' resource consumption.
- Strengthen account management of highly profitable accounts to ensure loyalty and prevent competitors from luring away any of these customers.

Lean, agile processes

A US wholesaler is interested in studying the costs of its processes in order to cut out waste and improve its agility in the face of market volatility. Until it adopted a profitability analytics solution, the wholesaler had no method for calculating the cost of its processes. After all, its processes were not reflected in its general ledger.

Now the company is able to calculate the costs of activities and, by assigning the activities to processes, calculate the cost of the processes. This work produces a cost-by-process report that shows resource consumption by each business process.

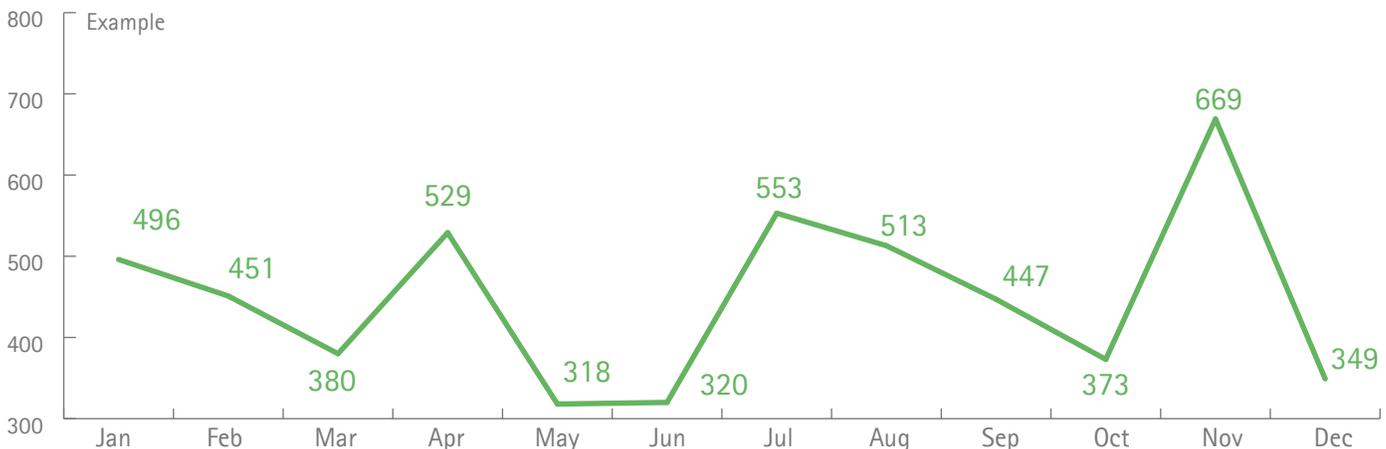
Managers can decompose the process structure down to activity level at the profit center – or roll up to the level of total cost for functions such as IT, Operations, Finance, HR, and Customer Services.

For each process, the wholesaler can now calculate and monitor the cost per output, per month, and predict trends. Figure 4 presents a process performance recap report that identifies monthly, itemized purchasing and procurement costs—showing what is possible when the process is in control. By understanding the underlying data, the wholesaler can identify the root cause of observed deviations in the cost per output and resource type and then take the necessary action(s).

As a result of this level of granularity, the company has been able to pinpoint:

- Where unnecessary time may have been spent (and transformed into cost)
- Groups of activities with no value-added output (waste)

Figure 4: Monthly, itemized total cost for producing a service



Source: Accenture, a hypothetical example

High-revenue customers may produce little or no net profit for the company. Is your enterprise able to identify these today?



High-level view: How to analyze profitability



To build trust within the organization for a profitability solution, there must be complete alignment with the profit and loss (P&L) statement in terms of total net profit. This means that the net profitability on all elements (products, customers) in the structure must sum up to the reported profit. Therefore, the solution design should include the following analytical dimensions (see Figure 5):

- General ledger
- Cost center (functional structure)
- Processes (value chain)
- Cost drivers
- Products
- Customers (commercial structure)
- Sales channel

Getting control over the general ledger is critical for a profitability analytics solution. To calculate the costs of activities — and therefore of processes in the value chain — it is essential to have responsibilities and the functional structure clearly identified in the general ledger.

Changing the financial and functional view to a process-oriented (value chain) view can create transparency across the processes. Even so, companies are still able to reconcile this view with the financial structures in place for tax and regulatory reporting purposes.

At a high level, a profitability analytics solution can involve these steps:

1. Ensure that the general ledger structure can deliver analytical cost category groupings (or summarizations of costs with similar behaviors). To do this, companies group accounts into meaningful categories.

For example, instead of examining individual categories of costs (e.g., salary types), they create a single analytical account for staff costs. This account would collect all the different cost items (e.g., salaries, office space, furnishings, equipment) that the staff needs to do their work.

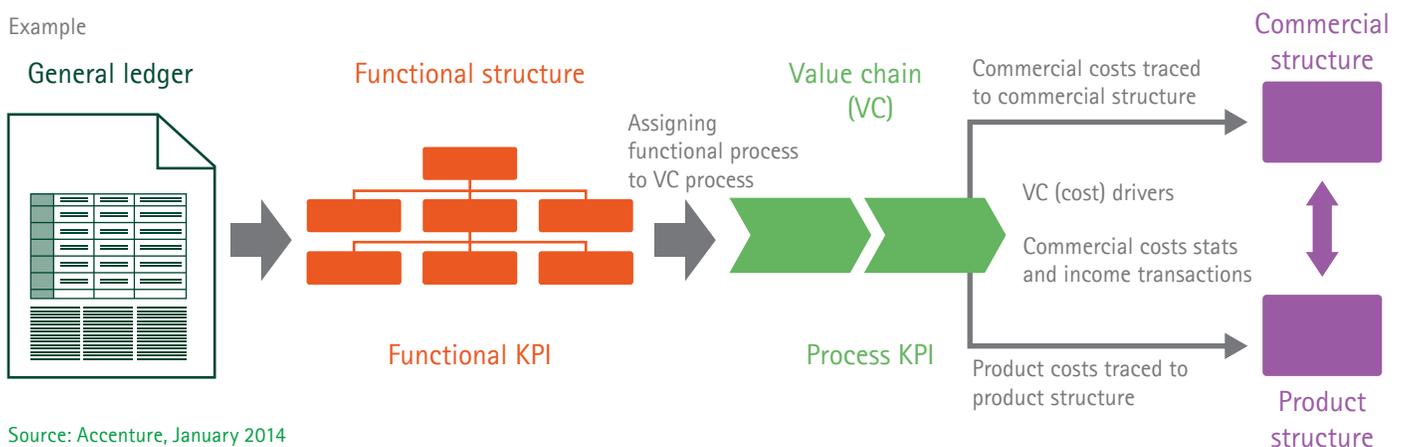
2. Identify a cost center structure where each cost center carries the costs that resources consume, thereby bringing all internal allocations back to the source.
3. Identify the process steps that are performed within each cost center and calculate the cost.

4. Align the main processes with the value chain at a high level. Assign process steps to each sub-process within the overall process hierarchy.
5. Identify the cost drivers (e.g., invoicing, order completion, warehousing, machining) and assign to the correct process.
6. Map the process cost drivers to the product or customer consuming the drivers. Drivers (e.g., sales orders, purchase orders, new products) are used to measure the consumption of processes. The sales channel determines the cost of sales.

In this methodology, costs associated with sales and administration-related processes are traced to the commercial structures of the business. Then, to trace these costs to products, companies use customer purchase statistics, actual sales records and other commercial attributes (examples: regions, channels, gender and income).

Figure 5: Analytical dimensions

Example



Source: Accenture, January 2014

Drilling down into customer profitability

In this hypothetical example, Customer A has purchased five products, with total revenue of €495. Through the following worksheets, the team has identified the total cost of providing these products to the customer as well as the net margin associated with this customer.

Based upon a traditional approach to identifying customer profitability, Product #4 and Product #1 would be considered the best products to sell (cash cows) to Customer A as they have the highest net margins (36.8€ and 36.2€ respectively).

Product #5 and Product #3 would be subject to further investigation given their low net margins (19.9€ and 13.6€ respectively).

However, when using a profitability analytics methodology (bottom worksheet), a new picture emerges.

The most profitable products to sell to Customer A are Product #5 (net margin of 35.9€) and Product #2 (net margin of 29.75€). By shifting focus to the sale of Products #5 and #2, resources can be realigned and used to increase the profitability of Product #3 which enjoys a very robust gross margin (95 €).

Despite Product #3's very large revenue, it does not enjoy stronger margins. As the product with the greatest revenue (120 €), it has the largest sales and administration costs (most number of visits) and uses the most customer support (processing of invoices/call support).

Figure 6: Worksheets for identifying profitability of hypothetical Customer A.

Example

Customer profitability P&L and gross margin allocation based on a traditional profitability calculation approach (€)						
	1	2	3	4	5	Total
Revenue	100	80	120	90	105	495
Product cost	30	25	50	25	40	170
Gross margin 1	70	55	70	65	65	
Sales and administration costs	33.8	28.2	56.4	28.2	45.1	
Net margin	36.2	26.8	13.6	36.8	19.9	133.3
%	36	34	11	41	19	

Customer profitability P&L and net margin based on a profitability analytics methodology (€)							
	Process drivers	1	2	3	4	5	Total
Revenue		100	80	120	90	105	495
Sales and administration costs	Number of visits	20	10	25	20	6	
Gross margin 1		80	70	95	70	99	
Customer support	Vendor invoice – customer support calls	12	5	13	7	9	
Marketing	Number of campaigns	1.5	1.25	2.5	1.25	2	
Gross margin 2		66.5	63.75	79.5	61.75	88	
Product cost		30	25	50	25	40	170
Gross margin 3		36.5	38.75	29.5	36.75	48	
Overhead	% of product cost	10	8	12	9	10.5	
IT	% of product, sales and administration costs	1.2	1	2	1	1.6	
Net margin		25.3	29.75	15.5	26.75	35.9	133.2
%		25	37	13	30	34	

Source: Accenture, a hypothetical example

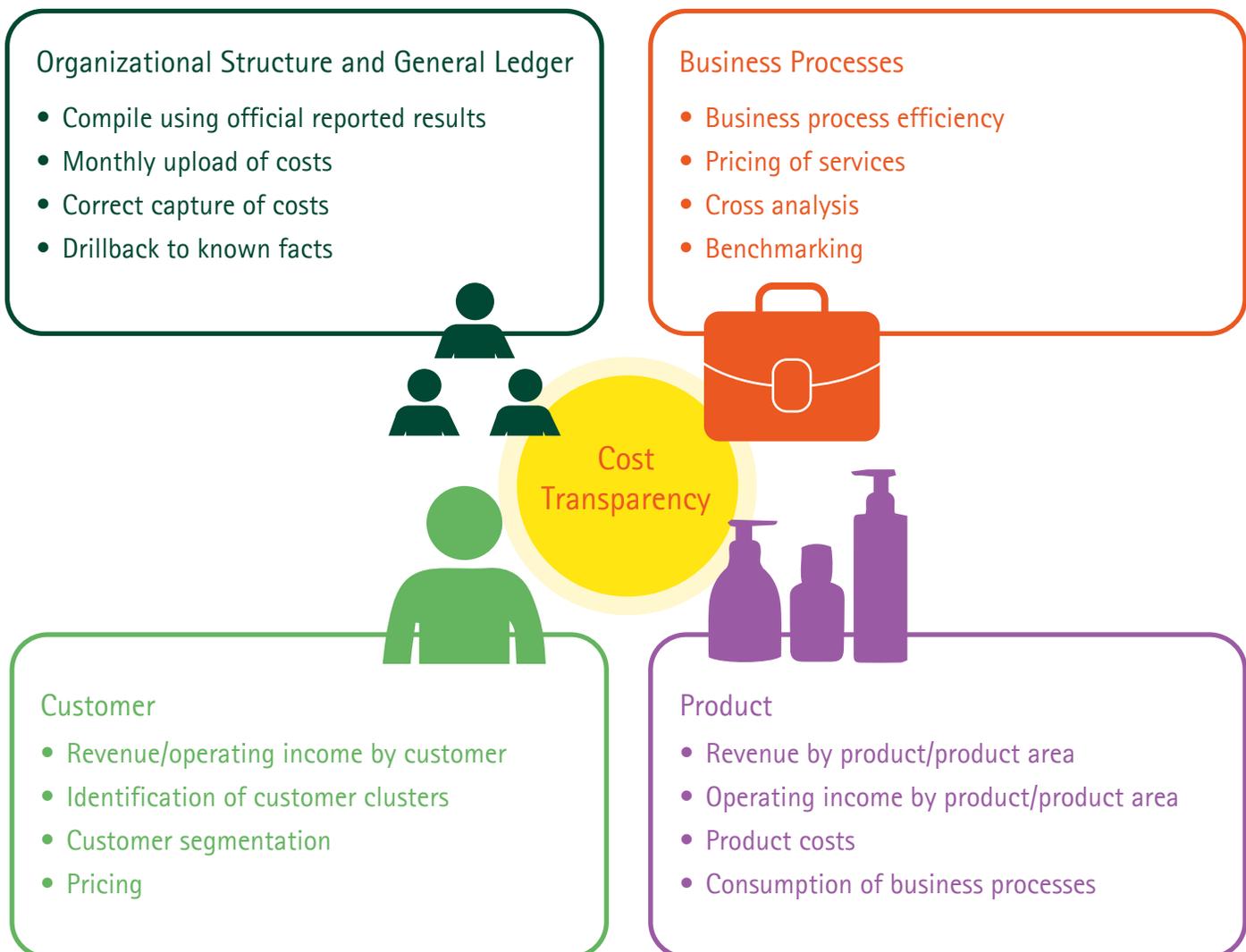
Five cornerstones enabling better decisions

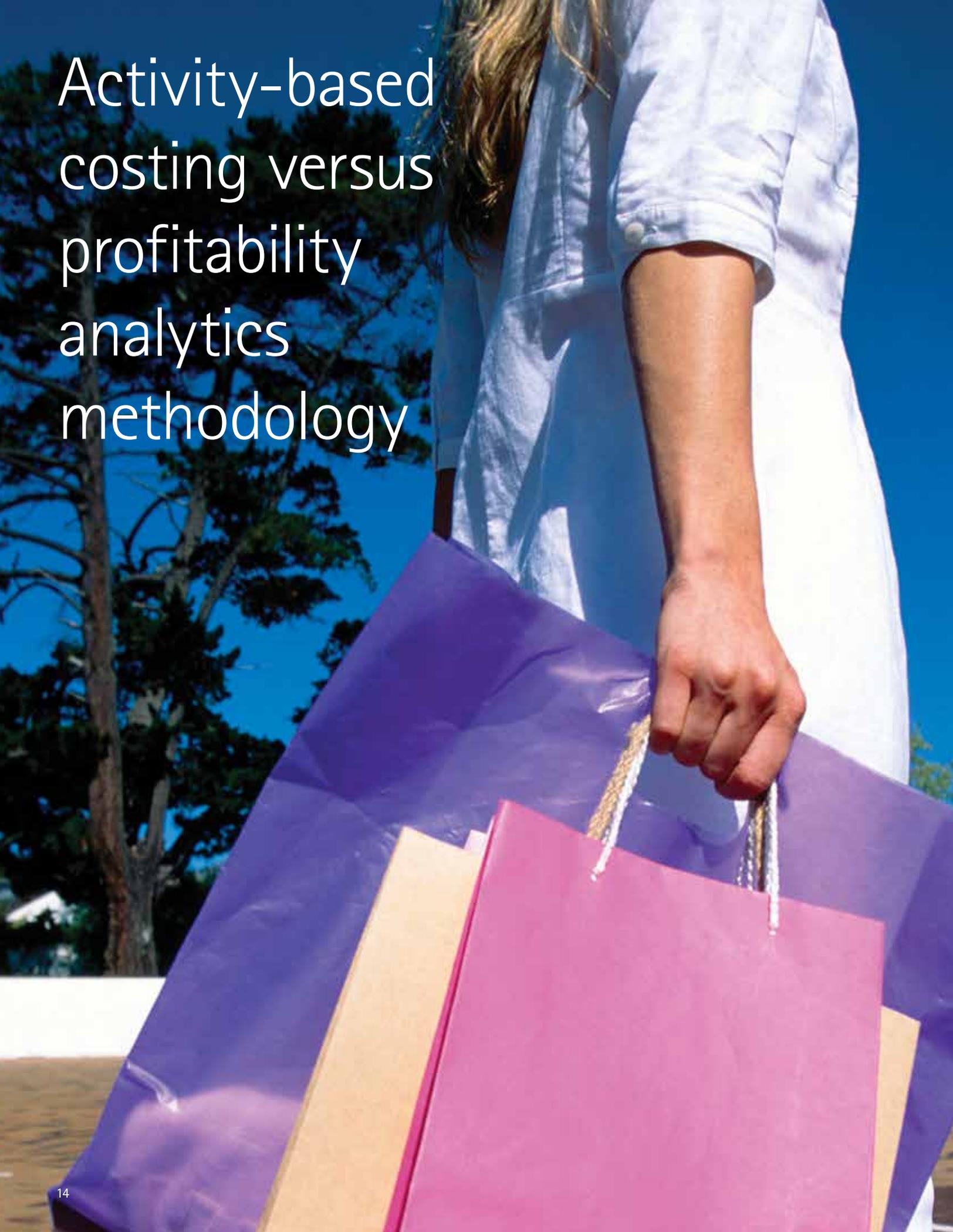
Profitability analytics is not a one-time calculation exercise. It is a live system intended for continuous use by decision makers. Therefore, it must be deployed to the business users who are actually making critical commercial decisions.

The solution is built on five cornerstones that can enable better decisions (see Figure 7):

1. Cost transparency is an important result of the solution. It is possible to identify why a cost is traced to a process, customer or product using transaction statistics.
2. The organizational structure and general ledger hold the basic information for the methodology – what cost is consumed where and by whom.
3. Process efficiency can be analyzed and improved, thereby leading to improved cost efficiency. Company executives know how resources are used and what is produced.
4. The costs – and the components of those costs – associated with producing a product are known. This data can be rolled up to the product group and product area level.
5. What customers buy and the revenue they generate is known. This data can be rolled up to the customer segment level. Changes in buying behavior can be identified and simulated.

Figure 7: Profitability analytics framework





Activity-based
costing versus
profitability
analytics
methodology

Activity-based costing (ABC) tries to solve the complexity of current cost allocation methods. It succeeds in some respects, yet the cost allocation is often quite complex to follow, but can be simplified and improved.

The number of drivers in the model is a key indicator of complexity. The more drivers there are, the higher the complexity. ABC assigns a driver to each activity; in contrast, the profitability analytics solution assumes that all activities within a process have the same driver (identified as the final output of the process). Where ABC might assign 150 drivers, for example, profitability analytics might assign 15.

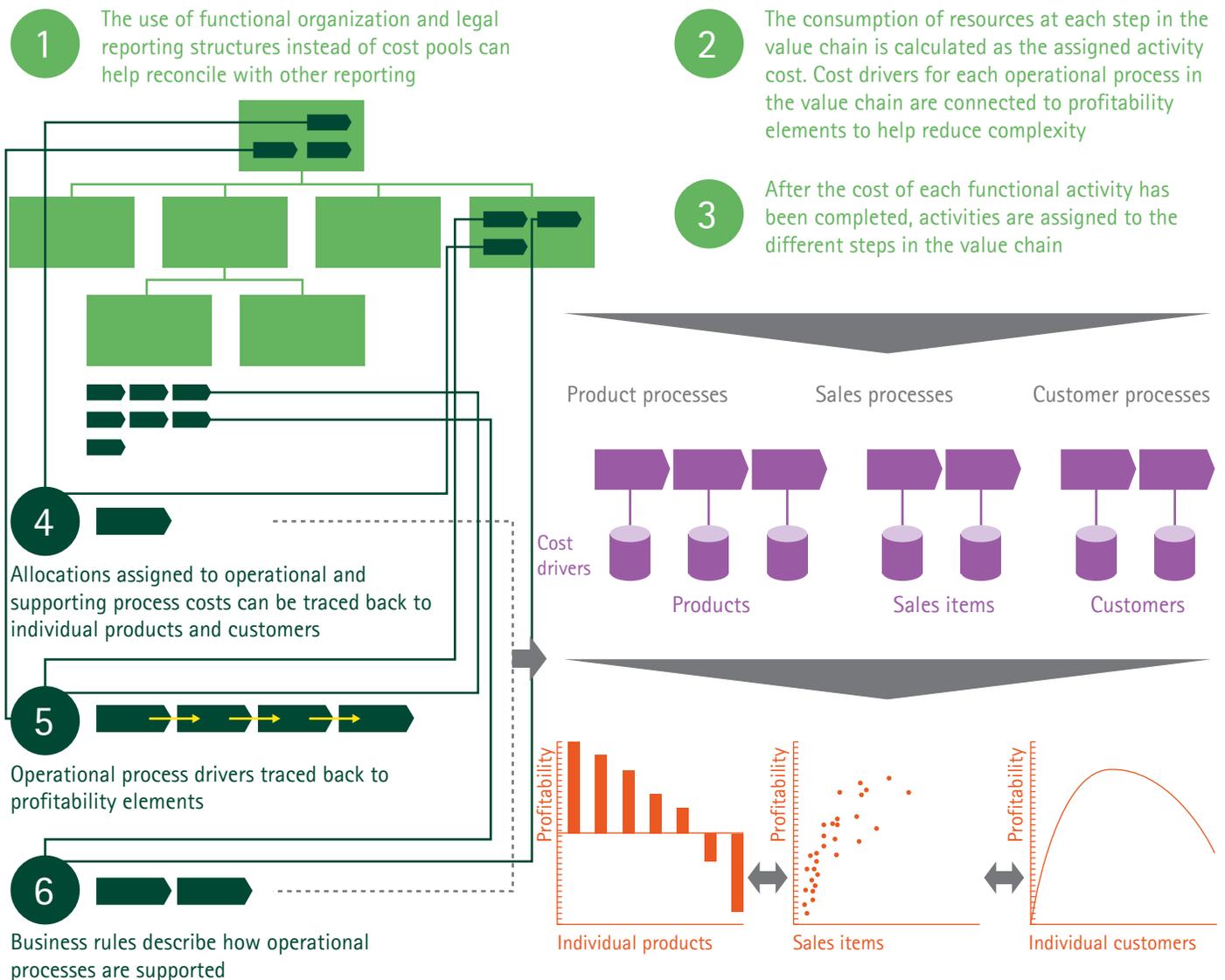
Simplicity supports one version of the truth

To build support for decisions based on a profitability analytics methodology, transparency in cost allocation is critical. Current top-down allocation methods do not support one version of the truth – it is all too easy, for example, to question why a specific percentage of marketing or sales costs was allocated to a given bucket

of costs. In contrast, bottom-up analysis provides a clear tracing of costs based on fact, not guesswork.

Change management is an important component of adopting this methodology. The cost transparency of this methodology helps generate buy-in for driving efficiencies in processes, changing resource allocations, and selling a different mix of products and services to critical customer segments.

Figure 8: Profitability analytics methodology



Source: Accenture, January 2014

What to expect and benefits of improved profitability measurement



When companies are considering adopting a profitability analytics methodology, they need to start that journey with the right expectations.

Staged approach. This type of project is often undertaken in stages. The first step is to study how the business is managed, what information is actually used to make important business decisions, and the impact of those decisions. Ask, "If better information were available, how would that affect the quality and speed of decision making?"

The next step is to run a proof-of-concept project in a well-understood area of the business, with the intent of demonstrating the impact of the decision support solution.

Each of these first two steps should be, at maximum, three months long. After the proof-of-concept is socialized and the approach proven, the implementation-and-build phase can begin.

Too often, training is left until after implementation or is cut due to budgetary or scheduling reasons. A better approach is to consider including training after each step for identified business stakeholders.

This timing has the added benefit of increasing stakeholder alignment and willingness to change. The total value of the solution flows from better information supporting more informed decision making.

Addressing poor data quality and cost transparency. This is often the largest hurdle, and it should be dealt with during the design stage.

Companies must determine the information they want from the solution and then ensure they have the necessary data. For example, if a company wants to know which of its

regions are profitable, it must capture not only which products customers buy but also the zip or post code in which the customers live.

Fixing data quality issues is critical to cost transparency. If people cannot believe the numbers presented to them, they will not support decisions based on those numbers. However, once a company can clearly show how costs are traced to a process, customer or product, that cultural hurdle can be overcome.

Heavy lifting at the beginning. The hard work in implementing the system occurs at the beginning, during design. If the solution is well structured, it mostly runs by itself. At that point, companies can focus on analyzing results instead of simply gathering data.

10 benefits of a profitability analytics solution

Profitability analytics can allow companies to:



1 Understand their true costs and profitability structure – thereby enhancing their decision making and proactive business management.



6 Reevaluate their value chain and business model, gaining strategic insights for succeeding in an uncertain and volatile business climate.



2 Gain greater transparency around the enterprise's cost agenda, discouraging counterproductive and siloed thinking and reducing silo management.



7 Figure out what to do with non-profitable products, including reworking the product mix configuration.



3 Improve some measurement of costs and profits – and therefore better manage their cost and profit agendas.



8 Focus on how to "package" the product offering to get the most out of the value chain.



4 Respond with greater agility to environmental and business paradigm shifts (across business units or across geographies).



9 Fine tune their customer offering, setting or resetting their customer strategies based on buying behavior and resource consumption.

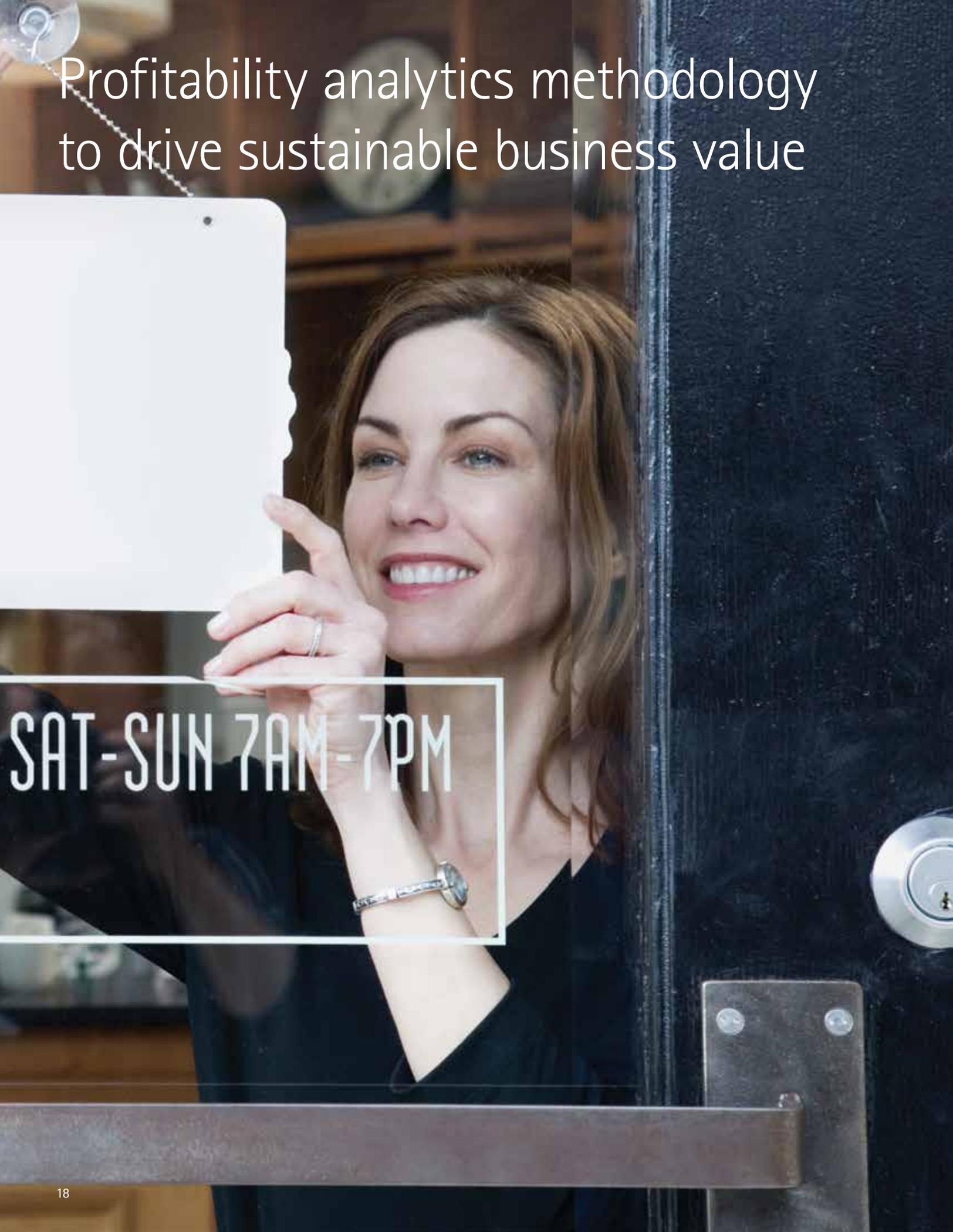


5 Target resources across the enterprise to drive value creation.



10 Use the different dimensions of their business model to execute effective multidimensional customer segmentation.

Profitability analytics methodology to drive sustainable business value

A woman with long brown hair, wearing a black top, is smiling and pointing at a whiteboard. She is wearing a ring on her finger and a watch on her wrist. The whiteboard is partially visible on the left side of the frame. The background shows a dark door and a clock on the wall.

SAT-SUN 7AM-7PM

As the business challenges and competitive pressures companies face across the globe intensify, so does the importance of understanding the profitability of products, services and customers. We believe this understanding is a significant differentiator.

The profitability analytics methodology and solution we propose can help companies define profitability at the product, service and customer levels. Furthermore, the consumption of business processes and resources will be transparent to decision makers. These profitability analytics capabilities can give business leaders what they need to make effective decisions. Timely, granular data about their net margins will help them tailor offerings and set competitive prices for the customers.

In addition, organizations may be able to identify customers that are decreasing the firm's net margin and raise a red flag if churn among the firm's most profitable customer categories is eroding the bottom

line. By using this methodology, companies may better understand their cost structure and root cause drivers—allowing them to distinguish among product, service and customer costs. These insights into cost interactions can make it possible to create the full cost structure of the business.

With this timely knowledge and ability, companies can be better positioned to understand the profitability of their business model and take the steps necessary to manage and sustain their growth agenda.



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David is a Managing Director – Accenture Strategy, based in Cleveland, USA. David has more than 27 years of consulting, industry and entrepreneurial experience working with clients and enterprises in more than 40 countries. An accomplished author, David specializes in advising clients on the challenges of doing business in an uncertain and volatile global marketplace focusing on strategy, performance management, risk management and analytics and guiding them on their journey to high performance.

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