

Analytics: Chief profitability officers still rare

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In a paper published in 2006, Jonathan Byrnes, a consultant and lecturer at MIT, argued that the chief financial officer should become a company's "chief profitability officer".

Mr Byrnes argued that as much as 30 to 40 per cent of a company's business is unprofitable, and that CFOs all too often have only a slender grasp of which activities make a profit – and those that run at a loss.

His research has been quoted frequently since and the basic premise of his argument has not changed much.

"In most companies, no one is responsible for systematically analysing and improving profitability. This is an astonishing assertion," he wrote on the Harvard Business School's website, Working Knowledge.

"The fundamental problem of analysing the profitability of orders, accounts, products, and services, and improving them through precisely targeted measures, falls between the cracks in most companies."

One reason is that the finance director or CFO lacks the time, tools and sometimes, the experience to tackle profitability. Dealing with compliance and reporting and running the broader administrative functions of the department can leave little time for more strategic work, despite its obvious importance.

The role of the CFO is changing, suggests Jim Hagemann Snabe, co-chief executive of SAP, the enterprise software vendor.

He says: "They are now more likely to want to analyse data in real time. The challenge is to optimise the business model across the value chain, where IT is not just about the back office but about moving the business forward."

Fortunately for CFOs with designs on improving profitability, businesses now have access to much more sophisticated analysis tools to help accomplish this than in 2006.

No longer must finance departments resort to spreadsheets and manual calculations to work out which products, or customers, deliver the best profits, and which make a loss.

Enterprise performance management (EPM) software gives finance directors the chance to drill down into individual product lines or customer accounts, and factor in the full costs of selling to customers, above and beyond gross margins and simple costs of sale.

Businesses have also gained experience in product-based profit management in areas such as retail, where merchandise and assortment optimisation tools are now quite widely used to understand the best mix of products to offer to maximise sales and reduce markdowns.

In retail, however, optimisation tools tend to be used by regional or even individual stores to manage inventory and sales. The software is not always connected to central systems, however, and this can deprive the CFO of a full view of profitability. EPM and other software tools aim to overcome this, by giving a centralised tool to look at profits across the business.

"Profitability modelling is best done outside ERP, because it is a very specialist skill," says Mr Hagemann Snabe. "But it needs to be integrated. You need to know your bill of materials and time consumed to give a true picture of the cost of sales."

According to Neil Chandler, a research director in the applications group at Gartner, the industry analyst, finance departments have been investing in activity-based modelling systems for several years. "But they have become too unwieldy, take too long to develop, or the cost to deploy them is too high."

In the past five years, though, the market for profitability modelling software has grown, both through ERP software, and modelling and business intelligence applications.

Some of the results of modelling can be a revelation for their users. According to Philip Young, manager in

the financial management department at Q8Oils, the lubricant producer, a project using EPM in north-west Europe helped the business reduce its transport costs.

The annual cost of distribution to the customer was €9m (\$12m). To run the EPM software more efficiently, Q8Oils cut the number of hauliers in north-west Europe from 88 to eight and at the same time, saved €1m annually by group tenders.

“Most companies have gross margin reporting at customer or market level, but our profit modelling goes a lot further. We have a lot of variable costs specific to the customer. We don’t just look at gross profit levels but the bottom line contribution to profitability, by customer, with these variables included,” explains Mr Young.

“The bottom line for EPM is to identify lossmaking customers or those with low profit contributions,” says Mr Young. “This helps the way we think. One of our strategies is to enhance the value of profits from niche products such as industrial and energy oils [used in wind turbines and gas engines]. We are investing heavily in research, which means we need to make higher margins on these products to cover those costs.”

At Gartner, Mr Chandler has seen even more impressive results. “It’s often said that 80 per cent of profits come from 20 per cent of customers, but the worst case I’ve seen was where 600 per cent of profits came from 5 per cent of customers,” he says. “That means many of the customers were destroying profits.”

He adds that CFOs must take care to distinguish between fixed and variable costs, as fixed costs will not disappear simply by cancelling the contracts of unprofitable customers. That, in turn, needs a good level of understanding of costs.

“In a small organisation with 100 products and 10 customers, you could do this in Microsoft Excel. But as you get bigger, there are too many transactions and influences to take into account – which is why you need software such as EPM,” says Mr Young.

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