FINANCIAL ANALYTICS SERIES

HOW TO MEASURE PROFITABILITY FOR ANY SEGMENT OF YOUR BUSINESS

flexible activity-based cost and profitability model

THE ISSUE

HIGHLIGHTS

Information, as distinct from data, is a fact or a figure that can be used, with limited analysis, by an organization's leadership in order to make a decision.

Today's corporate landscape is littered with the "dead-men-walking" of the information revolution. Many Wilshire 5000 companies have spent millions of dollars and thousands of person-hours designing, developing and deploying "mis-information" systems that ostensibly would have saved them many times their original investment. Needless to say, these investments have not panned out and continue to burden resource-constrained organizations with much of their valuable mind-share.

The failure stems from the fact that many of the designed systems are data heavy and information light. Information, as distinct from data, is a fact or a figure that can be used, with limited analysis, by an organization's leadership in order to make a decision. The most critical decisions are those that affect corporate profitability. Thus, the most important information systems are those that enlighten the company's leadership on how their collective and individual actions are influencing profitability.

Traditional accounting and costing systems give management a rear-view mirror understanding of corporate performance – "navigating by watching the wake of the boat." While this information can occasionally be useful, it is a poor replacement for real-time feedback on how an organization is doing. It is difficult to imagine leaders performing optimally without real-time information – decision-making that relies too much on prognostication invariably risks failure in the long-term.

In addition, traditional management support systems are designed to provide a cost-centric accounting window into an organization. In the rapidly changing business environment, decision-makers need access to an information pool that can be dynamically analyzed for fast-changing trends. The ability to analyze an organization's profitability from multiple angles will give management an advantage that many competitors lack. To ask what-if questions and have answers at one's finger-tips will allow the leadership of an organization to respond to stakeholder needs urgently and confidently.

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Designing a decision support information system with these characteristics is a daunting task and is often undermined by the misplaced desire to provide mountains of purportedly useful information. The key design element is to decisively analyze the core business economics to arrive at the information map that drives profitability. This core intelligence needs to be both simple and easy to understand by everyone in the organization.

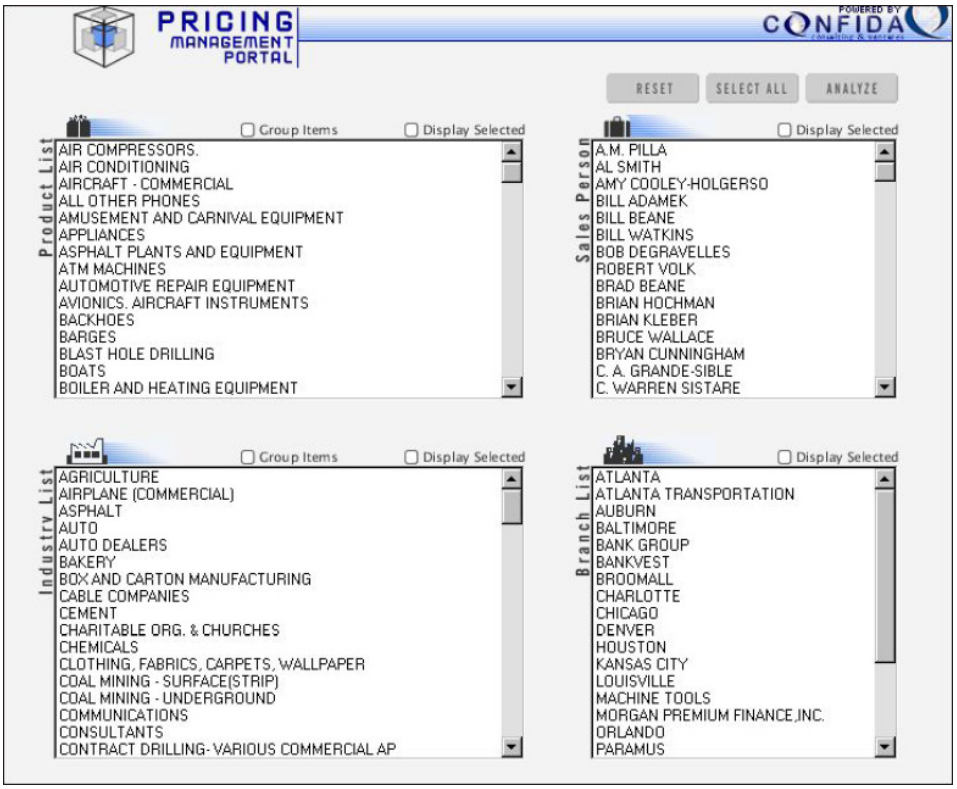

Figure 1

HIGHLIGHTS

The key design element is to decisively analyze the core business economics to arrive at the information map that drives profitability.

We refer to this core intelligence as the Strategic Profitability Information Network(SPIN). SPIN is a democratic network – the intelligence is accessible to all employees within an organization regardless of position. It might provide a different default window to a CEO than it would to a salesperson, but nonetheless the information is available to everyone. SPIN is a decision network – it is designed on the principle of "less is more." Any fact or figure that does not help an individual within an organization in making a decision is probably irrelevant. The simplicity of a decision network is critical in providing leaders with the ammunition to make agile decisions. SPIN is an elegant network – the design is prescribed to be simple and elegant such that even a new employee can understand how to navigate the system with minimal effort. Most importantly, SPIN is a segmented economic network – it is designed to provide hard profitability information for any cut of the organization. A CEO might be more interested in profitability at the corporate level, a branch manager is interested in the profitability of her branch, and a salesperson might be interested in the profitability of his book of business. The SPIN network is architected to provide bottom-line profitability figures for any segment of the business – in real time.

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IMPLEMENTATION & THE TOOL

Recently, we implemented a SPIN system at a financial services client. Our client had witnessed top-level profitability margin erosion over a five-year period . As it turned out, the margin erosion was not particularly common to the industry as a whole – some industry players were doing particularly better than others, the prevailing reason being that they had a better, more profitable book-of-business. There was no doubt that there were many operational efficiencies at our client, but the predominant reason for the margin erosion was the lack of a fundamental understanding of the economic drivers and ensuing profitability numbers. Business was being written for the sake of writing business regardless of the contribution to the bottom-line and many people in the organization had no access to any decision-aiding information sources.

The implemented SPIN system was both elegant and simple – a web-based interface accessible to all employees and compatible with our client's legacy systems (see figure 1 on previous page). The client defined the core profitability metric for the organization to be a target return-on-equity (ROE). The SPIN system measured profitability, at the corporate level, at the individual salesperson level, and at every level in between, against this target ROE set by the president.

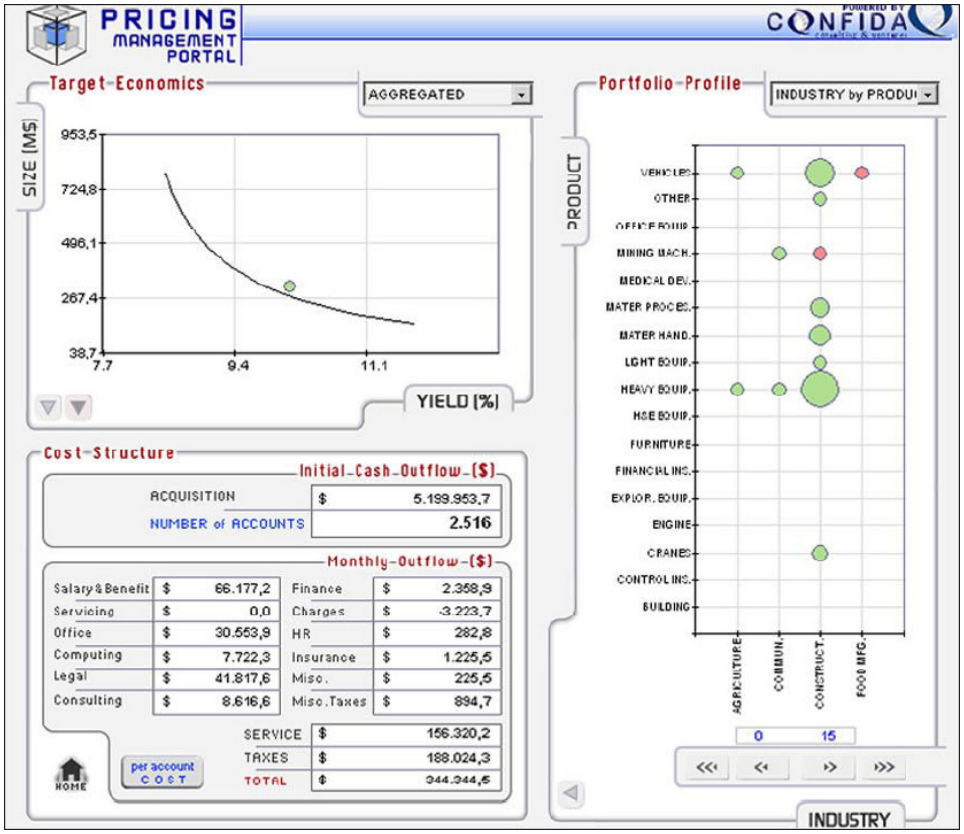

Figure 2

One could readily view, for any segment of the business (small or large), whether the target ROE was being met (see the bubble under "Target Economics" in figure 2) and how far from the target line that book-of-business was. A sophisticated activity-based costing approach was used to allocate costs for each segment of the business – the calculations were performed "on the fly" since expenses and revenues were constantly changing. Using the activitybased costing engine, the SPIN system was able to dynamically profile the economics for any segment of the business.

The information in the system was extremely useful for the CEO who could, for the first time, look at the profitability of the various segments of the business. He could then make strategic decisions regarding which direction to push the business and furthermore decide whether overall targets would need to be adjusted. The system was equally beneficial to the salesperson who could not only view whether his current book of business met the ROE targets, but could also analyze how new business would impact his threshold (see the bubbles in figure 3). The SPIN system, therefore, permits delegation and accountability across the organization because a powerful and dynamic metric system provides feedback at the right level for each interested party.

HIGHLIGHTS

This delegation of both authority and accountability is only possible, however, if the organization has a seamless, visible, and always-running measurement system.

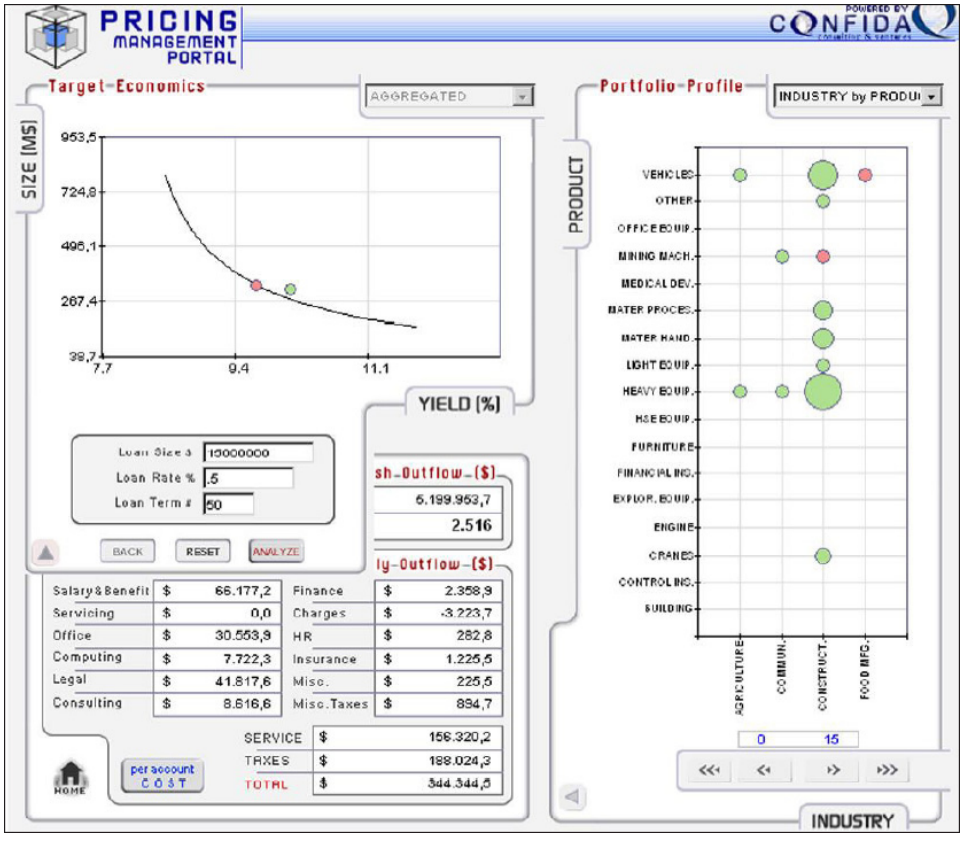

Figure 3

The system not only provided new insights for the organization, but it also allowed the client to modify the organizational accountability processes. In our experience, there is nothing more counterproductive to a sales organization than the micro managing of the staff down to their hourly tasks. Therefore, we encourage our clients to explore the

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concept of "macro leading" a sales force. This involves providing easy-to-understand, quantitative targets for salespersons and a measurement system that continuously tracks progress toward these targets. Salespersons are thus free to write the business they wish (occasionally perhaps signing on a loss leader) knowing how it affects their targets (which has visibility to the entire organization). This delegation of both authority and accountability is only possible, however, if the organization has a seamless, visible, and alwaysrunning measurement system.

CONCLUSIONS / IMPLICATIONS

The information provided by SPIN system allowed our client, at every management level, to make informed strategic or tactical decisions although in some cases judgement or gutfeel was used as well. The strategic information depicted, at some level, can be construed as minimalist - however, the information was carefully organized to include only what was material to decision-making in the organization. Everything else was noise. This condensation of data to information is the crux of designing a solid management decision-support system and it is imperative that system architects pay more attention to this phase of the process in order for information systems investments to pan out.