INSIGHT

DECEMBER 2018

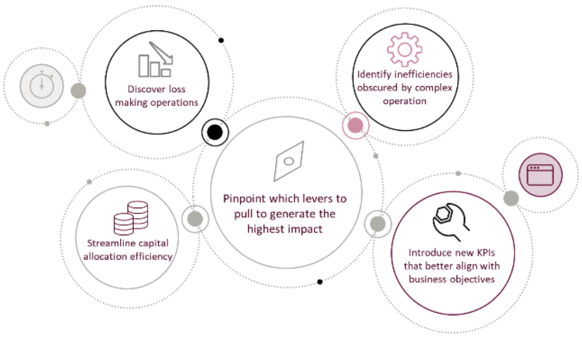
DRIVING GREATER PROFITABILITY THROUGH DEEPER DIMENSIONALITY

With only a view of gross profit by product category-level, a multinational telecommunications company has been inadvertently renewing loss-generating customers. Renewal discounts have been given without considering the complexity of the company's asset-base in different regions and costs-to-serve at the service level. Without a more granular view of profitability by customer account, the company does not have insight into what really creates value and drives the business.

It's likely your company can provide sales figures by product, geography or channel, but can your company properly allocate direct and indirect costs to arrive at gross profit or even EBITDA figures in the same dimensions?

Dimensional profitability models introduce a data driven approach to allocate costs to better match the multiple dimensions in which revenue is generated to give management greater insight and more granularity as to what really drives business value.

Why should you adopt a dimensional profitability model?



Where should you start?

Start with insight that can create the most value and quick wins

Businesses operate in different dimensions. Business decisions revolve around determining what products to promote, what customer relationships to keep and what channels to sell. Every company will have its own unique business objectives that will drive the prioritization of profitability dimensions. Therefore, to start adopting a dimensional profitability model, your company first needs to identify what dimension will yield the most valuable insight and start building the model from there. To start with a complex model with all dimensions at once can be overwhelming. To ensure that you only focus on want you really need, start by developing visualizations of the final desired output.

How far should you go?

Balance costs with benefits from improved decision making

Drilling down to every possible dimension may not provide much value for businesses catering to individuals, but yields novel insight for corporate customer accounts. Therefore, prioritizing dimensions that will create the most value as well as provide the optimal level of granularity to enable improved decision making will generate quick wins and stakeholder engagement.

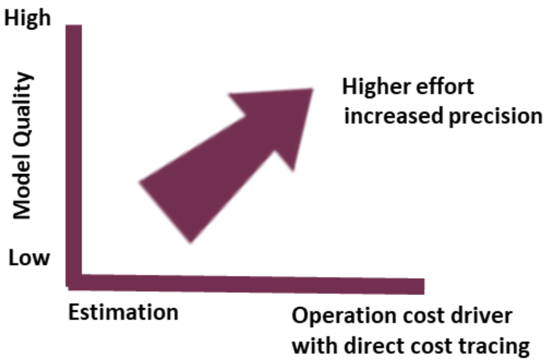
Whether to stop the dimensionality at gross profit level or drill down further to EBITDA or even to the net income level depends on how much the extra insight will contribute to managerial decision making. Below the gross profit line, deeper analysis of selling expenses or after sales service expenses can highlight the value of a customer relationship, a problematic product line, or even suspicious activities in a particular area. However, for administrative expenses such as back office personnel or management salaries, the benefits provided from additional granularity could be less than the cost of time and resources that need to be spent.

Dimensionality does not have to be limited only to profitability. It can be expanded to render more granularity in other performance metrics such as ROCE or profit per FTE.

What are the key considerations to implement this model?

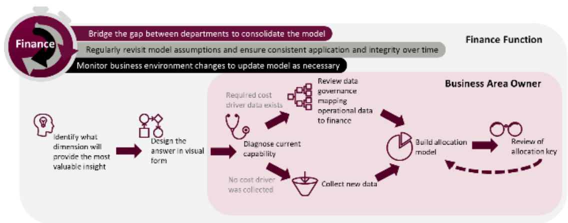
Process

In order to achieve a more granular view of profitability, a sophisticated cost allocation method is needed. A high-quality allocation key will rely on operational cost driver data with direct cost tracing such as data from individual stock keeping units (SKUs) or individual bandwidth utilization, whereas lower quality models might rely on estimation from operations managers. It is a good start to diagnose and determine your current capability. Data governance programs may need to be reviewed to map operational data in order to finance data and create linkages among various systems. New data may need to be collected in cases where no operational cost driver data was previously collected. Either way, finance needs to fully vet the assumptions and empirical measurements used in these models while balancing the level of effort and benefit to decision making.



The frequency of refreshing the model depends on the level of fluctuation in your cost driver data. The review of allocation assumptions can also be part of the annual strategic review or triggered by key events such as exiting a product line or a change in regulation. Frequent updates might not be advisable as the effort should be spent interpreting results and generating insights that support strategic commercial decision-making.

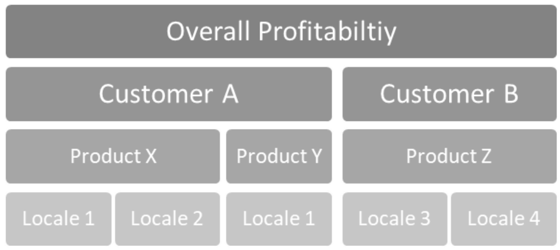
A new working model between business area owners and finance function has to be established.



People

Each dimension of a company's operation is connected to complete a value chain. To continue from the previous example of a telco company, a chain of different products serviced in different locations combine to create one customer account. How the value chain is structured differs among different industries; therefore, to get a complete and accurate view of profitability, the finance function will need a thorough understanding of business operations. This can be achieved through dedicated trainings or more involvement of finance function in operational processes and major business decisions such as launching of new products or acquisition of key customer accounts.

The whole dimensionality program should be driven and consolidated by the finance function where each business area owns and maintains the model in its dimension. Key stakeholders who will rely on the result for decision making need to understand the objective of the profitability model as well as how it works in order to feed in relevant operational data that will be the best proxy. The finance function's responsibility is to verify the integrity and consistency of the proxy over time.



Technology

Companies can choose to implement cost and profitability management applications that model business processes, capture costs as they happen, and assign costs along with revenue in all dimensions. However, before investing significant resources in a new solution, companies can first conduct a fresh review of existing technologies to ensure that they are effectively and optimally used. The remapping of databases across systems or a review of the chart of accounts may be sufficient to provide the desired level of granularity. Alternatively, as a quick-fix method, companies can utilize robotic process automation software (RPA) to repeat the process of collecting and allocating operational data if manually updating of the model becomes too labor intensive to support with existing staff.

Elevate the finance function to be true finance business partners

Consolidated and summarized profitability provides management with a quick check of the company's overall health as it gives quick analysis of the fluctuation in all revenues and costs. However, without knowing the true profitability of customers, products, regions, and channels, management is in the dark as to what key levers they can pull to maximize shareholder value. Achieving a robust dimensional profitability model also introduces new KPIs that can better align enterprise strategy with staff and department incentives. Knowing what really drives business value can elevate the finance function to be true finance business partners.

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