Data and Analytics
Managing a Profit-Focused Enterprise™
Difficulties in Choosing a Cost Management System
Differentiating Between Value-Added and Non-Value-Added Dollars
MANAGING A PROFIT-FOCUSED ENTERPRISE™

This article discusses techniques for bringing high definition to your Profit-Focused Enterprise.

IN HIGH DEFINITION

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High-definition technology is used to bring information (such as pictures, words, and numbers) into sharp focus, which enables us to truly immerse ourselves in the experience. Our executives want that same experience when it comes to understanding cost and profitability within their own organizations. For too long, they have been forced to work with “blurry” reports without important details because they were simply not available — largely due to technology. Much of the truly informative data is either buried in the details (to which they do not have access) or not in digital format — like on a clipboard or in someone’s head (to which they also do not have access).

Finally, high-definition technology and a management framework have arrived for financial executives, marketing executives, and others who need to manage a Profit-Focused Enterprise™ delivering the HD experience. Depending on the maturity level attained within the framework, organizations can expect to increase profitability by .5 to 2.5 percent of revenue or more.

The paradigm shift
Television — what an amazing invention! Since it was first made available to the general public in the 1920s, it was used as a delivery mechanism for advertising, a source of entertainment, and to provide news. Bringing entertainment

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COST MANAGEMENT
High-definition costing and profitability

So how does this relate to managing a Profit-Focused Enterprise (PFE)? With similar dynamics to TV’s evolution, companies are starting to experience similar advances in technology. This enables our finance departments to have increasingly clearer views into the profitability and cost of their organizations, and a better understanding of what customers, products, and services are driving business forward or into the ground. It isn’t that companies haven’t been focused on running profitably all these years; they have indeed been in pursuit of delivering superior returns to shareholders.

What’s changed is the technology used to probe ever deeper into the data beyond statutory, black-and-white, gross margin financial statements and into many more dimensions — HD attributes and the textures of true costs and revenues that align for a very precise picture of how profits are actually made. These technologies are powerful databases that house detailed data about the company’s operations and finances. This includes software that guides a finance user through mounds of data in various data-bases to create business rules that ultimately transform the data into meaningful, never-before-seen pixels on actionable, HD profit and loss statements, and high-speed servers to crunch through millions of calculations dictated by these business rules. As might easily be predicted, the harvesting of more and more data related to — but not owned by — companies (also known as big data) will bring even more richness to be immersed in when pursuing even higher-definition profitability.

Now, how is it done? Let’s break it down into four components:

1. the PFE™ framework;
2. maturity assessment;
3. sharing the HD experience; and
4. big data for the 4D experience.

The Profit-Focused Enterprise™ framework

To manage a PFE in HD, a pragmatic plan is needed — a structured framework, if you will. A PFE™ is one that that uses the same profit information across the entire enterprise to create strategies for day-to-day decisions. To use the same information, you need a standardized, repeatable framework to get you there. Oracle has developed a repeatable framework that is both simple and pragmatic for organizations struggling with execution.

The PFE framework is divided into four processes: (1) profit clustering, (2) revenue attainment, (3) operations optimization, and (4) resource alignment. Steps two, three, and four all rely on the profit clustering step (see Exhibit 1).

Step one: Profit clustering. Profit clustering is the core foundation of the framework. Before strategies and initiatives are developed, executives must first understand who, what, how, and where profits are generated. This is done by segmenting profitability into clusters, such as customer, product, service, channel, supplier, warehouse, process, flow path, sales person, and other industry-specific dimensions, using a powerful allocation platform such as Oracle Hyperion Profitability and Cost Management (HPCM). This analysis enables the enter-

and news to our living rooms from around the world was amazing, but the picture quality was mediocre at best. As television became a commercially viable standard in many households, technology began to move at a fairly rapid pace, bringing large improvements to the masses. We progressed from a viewing experience of grainy, black-and-white pictures to ones of color; from tubes to plasma and LED, and eventually to the addition of more pixels on bigger screens until we reached the highest level of life-like clarity and definition. Or so we thought. Moving to digital transmission formats now supports superior picture and audio combinations for a truly, in-your-face, body-shaking experience. And, as might easily be predicted, the last movie you saw at an IMAX 3D®, or even in 4D at a theme park, will be in our future living rooms. One day we will be completely immersed and have the total sensory experience at home.
prise to benchmark members of each cluster against each other to determine best practices.

Executive dashboards showing the top, middle, and bottom performers quickly enable analysts to identify opportunities. Segmentation also enables companies to analyze profitability by combining dimensions such as the most profitable products to the most profitable customers and channels. This combined dimensionality ensures executives are confidently making the best decisions after examining all points of view. Profit dashboards are delivered to each decision-maker: sales, marketing, supply chain, procurement, operations, etc. The typical profit dashboard designs contain three core elements: profit curves, strategic profit and loss statements (P&Ls), and benchmark analytics.

- *Profit curves* are graphs that show accumulated profitability by dimension. The vertical axis represents net profitability and the horizontal axis represents the reporting dimension (customer, product, channel, sales person, zip code, etc.). Data points are sorted from left to right on the axis, showing the most to the least profitable members (i.e., customers). The average company will show a line representing profitable members as the first 20–30 percent, marginal members as the next 40–60 percent, and least profitable members as the remaining 20–30 percent. (See Exhibit 2).
- *Strategic P&Ls* are management statements that show the profit details of the profit curve dimension being analyzed. Unlike financial P&Ls that are focused on statutory dimensions such as cost centers, accounts, legal entity, etc., strategic P&Ls provide a pragmatic view for executives to understand the relationships among customers, products, channels, suppliers, and supply chains, etc. These statements show “actionable” profit levers that allow decision-makers to drive profitability decisions (See Exhibit 2).
- *Benchmarking analytics* allow decision-makers to compare profitable, marginal, and poor-performing members against one another to determine best practices. A properly designed benchmarking process will contain filtering capabilities by dimensions that allow executives to quickly identify, compare, and inquire into anomalies.

Profit clustering requires the combination of all three dashboard elements to identify profit opportunities or initiatives. For example, imagine a grocery retailer pulling up a produce profit graph...
and drilling on the negative part of the profit curve to see what produce is destroying profits. After hovering on the tail of the graph, it is determined that tomatoes are losing money. After drilling on tomatoes, a strategic P&L shows the revenue, volume, cost of goods sold (COGS), and all actionable profit levers from the supplier to the store shelf. After adding another store to the dashboard to compare tomatoes, it is also determined that the customer service profit lever at store one is much higher than at store two. Why? A strategic initiative is created, and it is revealed that tomatoes at store one are often stored 24 hours longer before being stocked. This 24-hour storage period indirectly caused excessive bruising, spoilage, customer complaints, and eventually product returns.

**Step two: Revenue attainment.** Revenue attainment initiatives steer the enterprise to focus on customers and products. The importance of this step is to grow revenue profitably versus unprofitably. Executives begin by looking at existing customer best practices, targeted marketing, market basket analysis, product best practices, pricing considerations, buying trends, seasonality, and product-subsidizing strategies. This new information is then used to identify new customers with similar demographics and buying behaviors. Customers are often clustered into groups such as top, medium, and low priorities, so marketing budgets can be directed toward the most profitable opportunities. Initiatives addressing current customer segments can be initiated by benchmarking the top customers against the poor- and marginally performing customers.

**Step three: Operational optimization.** Operational optimization is achieved by understanding all the profit levers associated with revenue attainment. This is similar to the “matching principal” taught in Accounting 101 for period expenses, but instead it aligns costs to operational dimensions. For example, warehouse expenses are sometimes reported below gross margin when looking at product profitability. “Profitability matching” assigns warehouse profit levers to the products based on metrics such as time and product. Profit levers such as picking, packaging, and shipping are then

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aligned to the appropriate product. The profit levers used in this example to move products through the warehouse are compared to other products to determine non-value-added or best practices. Other initiatives considered in this step may include build versus buy decisions, outsourcing, policy reengineering, shared services consumption, vendor best practices, supply chain best practices, and transportation.

**Step four: Resource alignment.** Resource alignment is the final step in the framework. After identifying who, what, and where to achieve profit enhancements, the next logical phase is to realign capital and period expense resources to the most profitable opportunities. Management initiatives are created that connect resources such as information technology, customer service, engineering, facilities, stores planning, warehouse, etc. to the profitable customers and products. Why are the least profitable segments consuming the most expensive information technology resources? Why not shift the resources to more profitable segments for expansion? The same holds true for capital expenditures. Why not diversify and move equipment, land, buildings, etc., to segments that are more profitable? Return on investment calculations are created by segment to show the best use of investments dollars.

**PFE maturity assessment**

So now you have a framework, but how can it be implemented and used by managers and directors who have not been asked to think or work this way before? Culture change is often a difficult road block for executives wanting to make profit decisions differently. One of the biggest obstacles is convincing managers, who operate in departmental or product silos, to consider new technology, processes, and ideas and to share their data and collaborate.

Senior executives, sales, marketing, and operations all have different business agendas and want profit information in ways that best suit their functions. Sometimes poor decisions are made in an effort to support a very specific objective. A common example is the sales function, where compensation is based on revenue alone without regard for profitability. Conflicting agendas such as these often cause profit erosion due to the lack of profit transparency. One way to determine if profit erosion is occurring is to perform a PFE maturity assessment.

A PFE maturity assessment is a high-level review of how advanced an entity is with regard to the information it uses to make profit decisions. This review is a simple barometer to determine if a systematic framework is a feasible solution worth pursuing. Each profit decision a company makes is based on some readily available information. The type of information used determines the maturity level of the entity.

There are four PFE maturity levels:

1. Revenue only;
2. Gross margin only;
3. Net margin only; and

The first three levels are self-explanatory by their names as the maturity definition.

The revenue only level focuses on sales subledgers, invoicing, and point-of-sale systems because aggregate revenue information is easily assessable. If a company primarily uses revenue alone to drive customer strategies, then its maturity level is considered low due to the lack of transparency into profitability. Many publicly traded companies focus on driving revenue (top line), assuming that the net margin naturally follows. Unfortunately, they fall into the trap of driving revenue unprofitably because they sell products that are losing money, and thus net income percentages stay the same or even decrease.

The most common maturity level is gross margin only because it matches the corresponding COGS to the revenue generated by the customer. This information is generally easily assessable as well because statutory regulations require entities to track COGS for financial and tax-reporting purposes. Many enterprise resource planning (ERP) software packages contain programs that match revenues to COGS. If entities have older legacy systems, internal IT departments...
can usually write programs to compare net revenues against COGS by customer. This level is significantly more accurate than the revenue only maturity level, but it also lacks full transparency of all costs; therefore, many entities fall into the same trap as the revenue only level.

The third maturity level, net margin only, requires organizations to match all costs to the revenue dimensions consuming the cost. Often, the term “cost to serve” is used to track the expense levers to the revenue. The most common type of expense matching is typically the waterfall allocation methodology that allows back-office operations such as maintenance, accounts payable, customer service, administration, etc., to be tracked to departments that interact with customers and products. For example, if a maintenance department supports a warehouse that hosts a product, then the maintenance costs flow to the product and on to the customer. Companies that perform historically above their peers traditionally understand the net profit of their products or services by using the waterfall methodology, which is more accurate than the gross margin only level of maturity.

Lastly, the least common but most desired level of maturity is net margin plus (+). This is an extension from the previous net margin level, but it goes beyond the analysis of only one dimension. This level allows the organization to pivot profitability 360 degrees through multiple dimensions. A company begins analysis in one dimension and then cascades to other dimensions to understand the fully loaded costs associated with generating profits. Why is this important? Imagine deriving a strategy to eliminate a product that is consistently losing money in favor of a product that has a high profit margin. Before pulling the trigger to eliminate the product, one last analysis shows that the most profitable customer is the majority purchaser of the losing product. Further analysis shows that the remaining customers are very profitable with the same product. Now imagine eliminating the product, making the most profitable customer mad, and losing the other profitable customers as well.

Depending on the maturity level attained within the PFE framework, organizations can expect to increase profitability by .5 to 2.5 percent of revenue or more. So which PFE maturity level reflects your current operations?

Sharing the HD experience

Each member of the family has needs and wants with respect to HD television, and the same can be said with respect to cost and profitability information for different members of an organization. So far, we have been focusing mainly on the financial side of the equation for the chief financial officer (CFO) and other financial managers. But a profit-focused perspective truly pervades all decision-making roles in the enterprise. For example, viewing profit through the lens of a chief marketing officer (CMO) will enable him or her to make better, more informed decisions on who to attract, who to retain, and who to ignore. A customer skew analysis will help to sharpen the focus for the CMO and add more pixels to the analysis when making decisions on which markets to play in and what kinds of customers he or she wants to attract.

Over the last decade, there have been several studies completed and articles written by various business management luminaries on the practical steps of achieving a financial model based on customer profitability. Most suggest that a good first step is to perform a customer profitability skew analysis (see Exhibit 3). In fact, from years of research, it has become conventional wisdom that for many companies, 10 percent of customers are creating greater than 100 percent of their profit (the rest are either breaking even or losing money). But it is also widely acknowledged that very few companies can repeatedly perform a detailed customer profitability skew analysis that is accurate.

Customer profitability skew analysis. In a high-definition world, a well-built, scalable, and transparent allocation platform such as Oracle HPCM is necessary to build a detailed skew analysis (by cus-
customer, product, or other dimensions and attributes) and to ensure that a company knows where to focus its effort. It will also ensure that organizations can regularly produce a detailed skew analysis on demand.

To complete the cost analysis process with accuracy, complex, multi-step cost allocation models are required. To be credible, these allocation models must be able to demonstrate true cause-and-effect relationships between cost contributors and consumers. A credible and well-designed allocation model uses many levels of allocation and can require the computation of millions of individual allocation links. The relationship of accuracy and credibility to computation size typically makes the calculation of cost analysis models seem like a daunting operation.

However, performance improvements through software and hardware allow for sophisticated cost analysis models with significantly reduced calculation times. Very large customer profitability models that represent a P&L statement for each customer based upon each customer's unique financial and operational transaction history are now realistic options. The underlying data scale for a customer profitability model for any given monthly snapshot can be measured in hundreds of millions of records. Databases for model storage and data computation allow customer profitability skew analysis to benefit from the performance and scalability enhancements to tackle these large-scale data loading, computation, and query workloads.

The benefits of having a truly reliable and credible source of customer profitability analysis are immediately obvious to the business managers that begin using the information to better focus their organizations on pursuing high-return market segments, repairing poor performers, and examining new spaces from which to harvest additional profits. Having seen the benefits of customer profitability analysis, these users typically hunger for more granular or more situation-specific analysis that yields even better results.

Satisfying the demand for timely, relevant, and detailed profitability reporting can become a challenge as the management audience grows and becomes more sophisticated. A well-built, scalable, and transparent allocation platform can certainly bring a 3D experience to the finance department, but also to marketing executives, sales, customer relationship managers, and more.

**Big data for the 4D experience**

Big data has been getting a lot of hype over the last couple of years, but many believe without delivering a great deal of value. It is important to look beyond...
the headlines and establish just what is meant by big data and what can be achieved by using it.

Paul Sonderegger of Oracle said that the world is making a digital copy of itself and that 80 percent of all that data has been created in the last two years. Is this the definition of big data? Some of what has been created already clearly is, and the first part of our definition for big data is very much about the sheer volume of data, but this is not the end of the story. Another part of our definition is the variety of data. Variety adds another level of complexity — just because one has a lot of data does not necessarily mean it is all big data. Think of credit card transactions; millions of them are happening constantly, but this is structured data with the same type of information. Big data is about the integration of different types of data: structured (like the credit card transactions or data from a data warehouse) and unstructured data (such as social media posts, text, or pictures). The third part of our definition of big data is the speed of data, or velocity. Here, we are looking beyond batch processes into the realm of near real-time data, real-time data, and constant streams of data.

It is only when these three V’s come together (volume, variety, and velocity) that we truly have a definition of what big data is. Each part adds complexity and makes it harder to deal with, hence the lack of penetration into mainstream business. Until there is a way to use this quagmire of big data to gain business value, big data is not going to evolve beyond an interesting concept or a way of storing large amounts of data. To ensure it is useful, a fourth V is needed — value.

Big data can help with understanding the real nature of profitability for an organization. Big data can be mined for the appropriate attributes that define profitability and/or cost behavior, determining the causality of events and therefore greatly enhancing allocation models. Defining which elements within the oceans of data are immediately useful helps a business operate more efficiently. Big data cannot operate in a silo, and profitability applications cannot operate in a silo.

Big data needs to be linked with advanced data discovery tools and techniques (for example, Oracle Endeca) to help dive into the data and find the useful elements. This environment must be linked with profitability and allocation tools to realize the true potential of big data. Companies can then use these discoveries and insights to help drive defensible, realistic allocations and to inform their business intelligence strategies. Big data does not replace a traditional data warehouse, but instead supplements it. These discoveries will help to define new subject areas that are appropriate to move from the unstructured world of big data into the controlled, curated, cleansed environment of the data warehouse for use in ongoing management reporting. Wouldn’t that bring high definition to the data warehouse!

Imagine if an electronics distributor was to promote the latest smart TV using three months of free access to movies. The distributor could use information from social media to monitor the sentiment around the offer and to target specific demographic groups. The distributor could bring data from the sales systems to monitor any change of volume in sales as well as the renewal rate for the movie package at the end of the offer period. If the distributor was running a single offer, this would be enough — it could monitor increased revenue and change in profit. Did the increase in people taking the offer track with the increase in renewal rates, too, or did profit stay level? Using advanced allocation systems, the distributor can ensure that any increase in costs — shipping, installation, help desk, etc. — are correctly allocated to the product and the offer across multiple products, channels, customer segments, and packages. This offers insight that helps to determine the correct mix going forward to ensure that the distributor is increasing sales to its most profitable customers, rather than to those for which the organization is really at the break-even point or worse.

Correctly incorporating big data can help move you from a high-definition 3D experience to a 4D experience.¹

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Conclusion

The components for managing a PFE are becoming more and more sophisticated — most of us are already out of the black-and-white reporting era and at least seeing results in focus and in color (or with some color). Taking the next step in the management reporting evolution is up to you. To see results in high (or higher) definition, consider using the PFE™ framework. To really sharpen focus, consider including a maturity assessment in conjunction with the framework.

For the full 3D experience, consider adding a customer profitability skew analysis to the mix. This informative lens on the business will enable marketing executives, sales executives, and customer relationship managers to really focus on which customers to attract, which customers they need to work with differently to make them profitable, and which customers are not ideal for the company to deal with.

Finally, to experience the fourth dimension — to get a life-like, in-your-face, body-shaking experience — consider adding big data into the mix as a credible source of behavioral information to truly understand and act upon profitability and cost information.

These four components will provide you with the ability to manage a PFE with amazing definition. Now, it’s up to you. What kind of “viewing” experience do you need?

NOTES

1 Where 4D TV refers to the added dimensions of smell or movement/touch; in this case, it refers to the addition of public sentiment or other big data that was previously unattainable.

2 IMAX is a registered trademark of IMAX Corporation; Profit-Focused Enterprise™ Trademark by Oracle Corporation; Profit-Focused Enterprise Framework™ Trademark by Oracle Corporation.