Analyze the Future

Global Headquarters: 5 Speen Street Framingham, MA 01701 USA P.508.872.8200 F.508.935.4015 www.idc.com

I D C E X E C U T I V E B R I E F

Profitability Management: Using BI and Analytics to Make Better Business Decisions

March 2009

Adapted from *The Profitability Perspective: How Automated Reporting Drives Better Decisions,* by Kathleen Wilhide, IDC #213429; and *Worldwide Financial Performance and Strategy Management Software 2008–2012 Forecast Update based upon Economic Indicators and 2007 Vendor Shares,* by Kathleen Wilhide, IDC #215093

Sponsored by IBM Cognos

Introduction

In today's volatile business environment, organizations in every industry must look beyond traditional cost-cutting measures and margin management to increase profits. One key way that organizations can drive sustainable profit growth is through robust and consistent profitability-focused planning and performance management. By implementing profitability management activities enterprisewide utilizing business intelligence reporting solutions, planning and budgeting capabilities, and analytics software, organizations can achieve visibility into accurate profitability information — information that various departments including finance, sales and marketing, and operations — can use to make decisions designed to drive revenues and manage costs optimally.

According to IDC, most companies have some type of profitability reporting. However, many of these companies are investing a lot of effort to produce relevant profitability information, and there are still limitations to the information companies currently compile. This information disconnect may have a significant impact on decision making. Manual processes, disparate data sources, a lack of sophisticated costing processes, and an inability to drill down to the details all hinder the ability of business managers to make well-informed decisions that can drive profits.

The good news is, software can make a significant difference in both the quality of information as well as expanded access to decision makers. IDC has seen significant growth in the use of software to manage profitability, and in the face of economic pressure these solutions can play a pivotal role.

This Executive Brief will explore how organizations can utilize profitability management systems to improve both operational and financial decisions that ultimately drive revenue and deliver profits.

The Current Challenges of Profitability Management

Financial performance and strategy management solutions consist of applications whose main purpose is to measure, analyze, and optimize financial and business performance and analytic processes. Finance departments use these applications to drive management reporting in support of enterprisewide performance management. These include budgeting and planning; financial consolidation; strategy management and profitability management.

Organizations are increasingly looking to software to support their profitability management reporting in order to gain greater accuracy and visibility. Software enables more complete or sophisticated cost allocations such as activity based costing for products, resources and services, or shared services allocations. This enables a more accurate matching of resources and other costs to product or services revenue that expands insight beyond traditional accounting.

Currently, there is a misalignment between the importance of profitability information to the enterprise and the methods and supporting systems used to produce that information. In particular, spreadsheets typically serve as the "system of record" for organizations, providing high-level results but falling short of requirements for deeper analysis to support real decision making. Spreadsheets limit the ability to increase the frequency of reporting and to respond to management requests for information, and they pose a significant risk of error — factors that inhibit a sustainable profitability reporting process.

Additionally, planning profitability targets is many times an exercise in cost center budgeting that is then rolled up into high level profitability reports. While there is value to that process, the more detailed insight into real profitability drivers is missing.

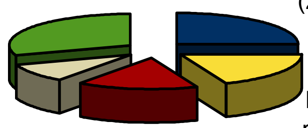
IDC research reveals that many organizations are realizing this 'information gap' and are investing in profitability management solutions to improve that information. IDC predicts that the market for profitability software will shift to vendor purpose-built solutions for profitability, and by 2013, the annual spend for packaged profitability solutions will approach $1 billion. Many of these profitability management applications combine software logic to support detailed allocations with a business intelligence (BI) framework that combines more sophisticated analytics. From a business user perspective, these solutions offer capabilities that lessen the reliance on IT, and provide connectivity to spreadsheets that make the solutions easy to use, yet are a structured part of enterprise reporting.

While profitability reporting is an integral part of information delivered to management teams and field personnel for over 70% of 600 companies surveyed by IDC, virtually all of those companies cited limitations in their current profitability reporting processes. Figure 1 highlights the top limitations identified by respondents.

Figure 1

Limitations of Current Profitability Reporting

Q. What are the limitations of your process or system for profitability reporting?



n = 600

Source: IDC Profitability Study, 2008

In the areas of statutory and management reporting as well as planning and budgeting processes, IDC finds that organizations are being asked to report and analyze more frequently and with more details than ever. The result is that organizations are feeling the burden of processes that are based upon excessive manual effort and are supported by complex spreadsheets that pose the risk of error. As management makes more demands for detailed information, business users cobble together information from disparate systems. When it comes to profitability, the alignment of costs with revenues are many times only as good as general ledger accounting and cost center budgeting results, with no real sophistication that can help organizations see where profits are being earned and opportunities lie. For example, many organizations report having difficulty identifying the 10% of customers who contribute to 90% of profits.

The range of systems users employ to support profitability reporting includes the most simplistic reporting as part of the general ledger, attempts at more refined results using BI reporting tools or budgeting solutions, or attempts at complexity by modeling costs in spreadsheets. However, implementing dynamic decision support that impacts the bottom line requires complexity and sustainability for which more purpose-built technology adds real value. This has driven a new category of performance management software on the market known as cost and profitability management solutions. The key to success in profitability management is to leverage technology to integrate information into a framework of cost assignment and revenue tracking that is scalable and flexible and supports a repeatable model for profitability planning and reporting that facilitates decision making. This requires an extension of traditional general ledger reporting solutions, which are not designed to support this level of detail or complexity. Those companies that have already made an investment cite a more strategic use of profitability information that extends outside of finance.

The Benefits of Profitability Management

As organizations realize the disconnect between the current manual effort to produce profitability information and a resulting lack of timeliness and accuracy, it is becoming increasingly clear that profitability reporting processes are ripe for improvement. Indeed, one of the key drivers of improvement is the fact that companies are moving toward more sophisticated cost assignment practices. While some adhere to strict activity-based costing or full absorption costing methodologies, many tend to use a combination of several methods, and more robust allocations that are defensible are a key part of the equation. Many organizations start by modeling costing in spreadsheets, but this process is not sustainable.

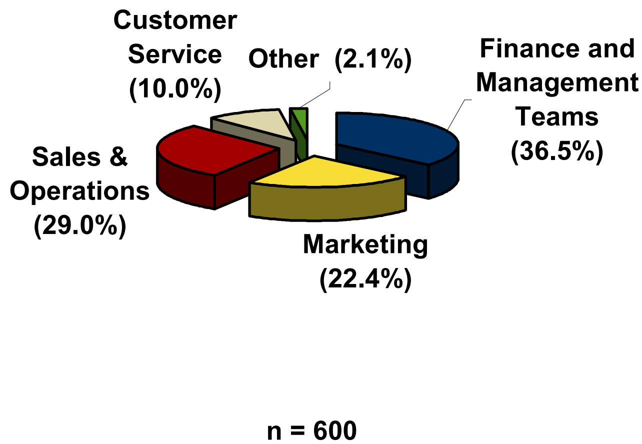
As organizations endeavor to better understand and assign costs, general ledger systems and BI reporting alone do not deliver the granularity organizations require to determine true profitability. As a result, finance spends a lot of time cobbling together information that is limited by manual effort, yet is pivotal to providing key insight across the organization.

Typically, finance is the gatekeeper of financial information and is in the best position to calculate profitability information. Consequently, finance almost always owns reporting. However, from a decision-centric point of view, profitability information must be delivered to key stakeholders across the organization for it to be meaningful, as indicated in Figure 2.

Figure 2

Who Uses Profitability Information?

Q3: Who in your company uses profitability information?

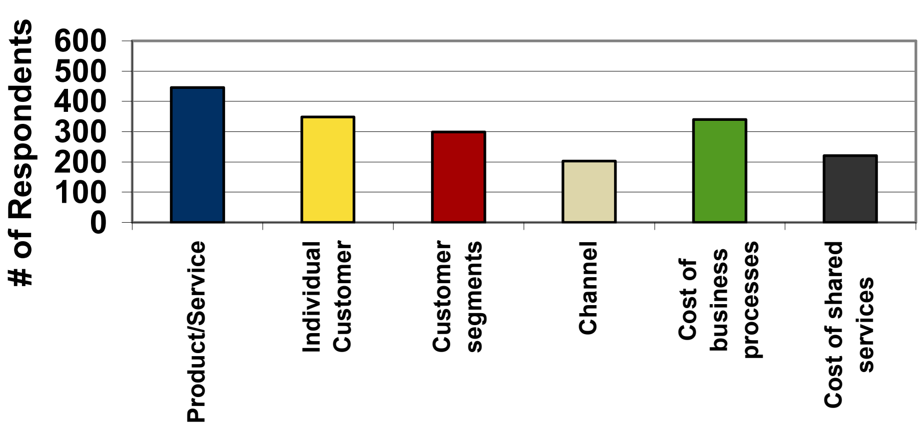


Source: IDC Profitability Study, 2008

As operational groups leverage profitability information, the need for multiple, yet reconciled, views of profitability expand, as indicated in Figure 3.

Figure 3

Requirements for Profitability Insight



Source: IDC Profitability Study, 2008

Meeting the myriad of user and information requirements with a single reporting and analysis platform for profitability management can result in several quick time-to-value improvements such as the following:

- A reduction in the manual workload
- The ability to produce more accurate information
- The ability to produce reports more frequently
- New insights not visible in general ledger results

Such improvements in the nuts and bolts of how profitability management is conducted establish the foundation for deriving significant decision-making benefits. Key external go-to-market decisions that organizations make based upon profitability data include customer-based decisions, such as highlighting those customers that are most profitable or represent the best chance for up-sell opportunities, or more dynamic pricing decisions. In a broader business context, a single and integrated platform for profitability management can help organizations achieve the following capabilities:

- Increased transparency into profitability
- Visibility into business results at the operational level
- Accurate information to guide investment/disinvestment decisions
- Enhanced planning and budgeting results
- Better resource allocation
- Improved understanding of shared costs, which can be used for benchmarking against outside services
- Shortened reporting times
- Repeatable, consistent reporting processes

In effect, a single platform for profitability management enables an organization to more easily identify both under-performing areas of the business as well as opportunities for growth. In addition, enterprises are better equipped to model cause and effect in areas, such as pricing and customer retention decisions during enterprise planning processes. And a single platform for profitability management enables end users in various departments such as sales and marketing as well as finance, to understand in greater depth why targets are not being met, and to make decisions using the most accurate and timely information. Indeed, an enterprisewide approach that a single platform can facilitate takes profitability management to the next level for many organizations.

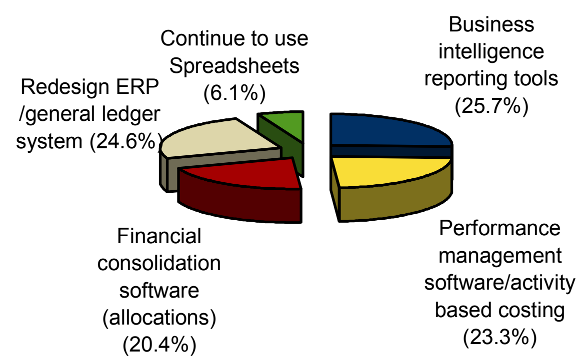
Considerations

Many organizations are aware of the importance of profitability management; companies attempting a more rigorous costing methodology typically begin by using spreadsheets, and as complexity grows, the ability to adjust to changing market conditions and refine models as required becomes cumbersome. Hence, the need to improve profitability reporting. Yet there are several obstacles to organizational plans to improve profitability reporting. Historically, cost and profitability reporting was prepared manually by finance on an infrequent basis. Organizations find it hard to make the leap from an initiative conducted by just a few employees to making a software investment. This mindset is changing, and organizations are embarking on broader performance management reporting strategies that are based upon a single platform of technology and information delivery. Processes such as planning and budgeting, management reporting, and profitability management are all elements of a sustainable management reporting platform, as shown in Figure 4.

Figure 4

Software Investments to Support Profitability Reporting

Q: If you are evaluating software, or will be making a software investment to improve your profitability reporting, what are your plans?



n = 458

Source: IDC Profitability Study, 2008

Solutions on the market have evolved over the past several years, and IDC sees this software segment rapidly evolving into the category of enterprise software. End users are just becoming more aware of the purpose-built profitability solutions available on the market today. A more robust set of delivered applications is evolving to support profitability that will enable organizations to leverage the information in their existing systems, apply more accurate costing practices, and produce more accurate and timely profitability reporting at the customer, product, and business segment levels.

Conclusion

In today's economic climate, many organizations are struggling to find areas of growth. One way to identify potential growth areas while also putting a spotlight on under-performing areas is through profitability management. Organizations are moving away from high-level, point-in-time profitability reporting characterized by the use of spreadsheets, and are making investments to automate profitability management and reporting processes. Those companies that already have already made this move readily report ROI related to improved decisions and manual workload reductions that exceed the cost of investing in software.

The benefits of having information that expands the organization's understanding of where profits lie — whether in terms of customers, product lines or specific markets — far outweigh the costs, and an investment in a platform to support these efforts is an investment in accuracy; a sustainable, repeatable process; and the ability to deliver information to support true day-to-day decision making. As organizations strive to respond to market dynamics with refined pricing strategies and focused marketing campaigns, a fact-based foundation on which to make these decisions is key. IDC recommends that companies strongly consider the capabilities for profitability management that are on the market today.

COPYRIGHT NOTICE