How to improve business performance thanks to a holistic follow-up of the CFO

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As corporations are exploring new ways of profitable growth in increasingly complex business environments, CFOs must reinvent their function and expand their scope of knowledge by using a three-dimensional framework of profitability assessment, ensuring that appropriate levels of performance measurement are available at corporate, product and client level.

In order to properly optimize corporate performance, today's CFOs should ensure that the firm's profitability effectively reflects the current and prospective performance at different levels of the organization. In doing so, CFOs should strengthen their in-depth view of their businesses and develop innovative reporting tools and analyses to support strategic decisions in complex and dynamic environments. The biggest challenge for CFOs is to go beyond the traditional costs and revenues approach, by developing a brand new three-dimensional analytic approaches of their corporation focusing on understanding their clients and products while keeping track of the nature of their costs and their overall profitability.

This requires CFOs to develop more business-focused skills in many areas of their organization and acquire a strong knowledge in operational performance, sales management and product portfolio management. Eventually, by developing this insider view of each area of their corporation, CFOs will increase their ability to deliver business managers and boards with tailored analyses. This process will ultimately reinforce the ability of corporations to implement more targeted strategic decisions and boost short- and long-term profitability.

Once these new performance indicators and objectives are established, CFOs should develop a clear road map of future initiatives and prioritize them, to efficiently improve corporate performance in a cost effective way. An efficient governance system should also be in place to empower leaders and gather the people that will ensure that targeted goals are met. It is also critical to conduct this three-dimensional profitability analysis on a regular basis (and not as a single exercise) in order to ensure that remediation actions are established and controlled, and can ultimately positively impact financial results.

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Step 1. Increase accounting and reporting transparency to facilitate more mature profitability assessment capabilities

Appropriate bookkeeping systems. For CFOs, the fundamental step is to ensure that appropriate bookkeeping systems are in place in order to track basic results of operational performance and highlight major operational inefficiencies.

One important milestone is to ensure that reliable corporation-wide information systems are implemented to perform in-depth analysis at each level of the firm. Corporations may also rely on data mining, big data and powerful statistical tools to provide a better understanding of their businesses to uncover unknown relationships between the different layers affecting the overall profitability.

Accurate revenue tracking. In the first stages of this framework, corporations shall reinforce their ability to measure and forecast revenue generated at the most granular levels. It is fundamental for CFOs to understand their sales at the consolidated level for:

- Products and the portfolio of products
- Clients while taking into account all the affiliates on a regional and global scale when relevant. For global businesses, for example, estimating sales for products available worldwide or for large and diversified clients is often challenging: this requires efficient harmonized consolidation tools and extensive analyses

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In-depth understanding of costs. In subsequent stages of maturity reporting, corporations will acquire a stronger vision of the nature of their costs while increasing their ability to allocate costs by products and clients. Corporations need to capture the fundamental nature of their costs by breaking them down into several categories. These different categories could be:

- Direct costs, which are often called "true costs" of products and services. These costs are usually better understood and easier to allocate to specific product lines. An important challenge associated with some direct costs which are variable, is their volatile aspect. Indeed, in a wide range of industries, profitability relies heavily on the ability of companies to anticipate future levels of costs (i.e., raw materials costs, oil prices, etc.). For this reason, corporations should build reactive monitoring systems in order to adapt their pricing strategies with their current sourcing costs in real time
- Indirect costs need a close attention as well, especially since these costs are usually harder to grasp. Corporations must build a comprehensive view of all their cost and profit centers and understand the major drivers behind them. In large and global companies, indirect costs represent a significant part of the overall cost structure and therefore it is important to accurately capture them so as to get a complete picture of the whole profitability and not a marginal profitability view based solely on direct costs

"Activity-Based Costing" (ABC) is found to be a relevant method for CFOs to identify the main cost drivers for all the different activities, products and services provided. ABC actually aims at allocating all the costs (direct and indirect) associated with each product or service produced based on the real consumption of all the different types of inputs used in the value creation process. Total costs are then derived by multiplying the total cost per product with the total volume for each product.

One major drawback of ABC is that firms have to develop complex models which may not be relevant for industries where products or services delivered to clients are highly customized or tailor-made. In such cases, cost drivers are hard to identify and ABC models become too complex and difficult to build and maintain. By using simplified models such as the 80-20 view, which allows a 20 percent margin error on profitability assessments, CFOs may build efficient ABC models while saving time and resources.

This approach must beused carefully, however: inappropriate, indirect costing systems may lead to under or overestimated costs associated with specific products or clients. Therefore, consistently updating and restating allocation keys properly is crucial in developing and maintaining strong reporting and planning systems.

Test and trials approaches along with benchmarking exercises could also be used to further improve analyses. CFOs should keep in mind that incorrect cost allocations may favor some competitors playing with better allocation rules, enabling them to boost their market shares.

In addition, ongoing assessments and evaluations should also be conducted - what was obvious in the past may no longer be relevant today.

Step 2. Go from cost analysis to cross-dimensional profitability measurement

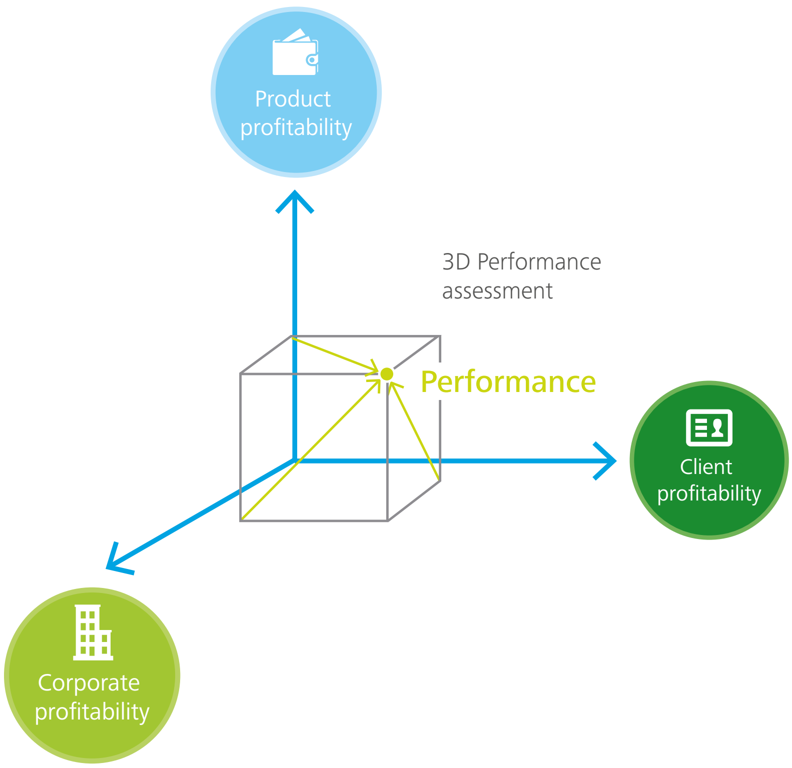
Three-dimension vision of the firm's profitability. Given the dynamic aspect of the market, CFOs should challenge their traditional cost and revenue approach with more specific metrics aligned with current focuses and evolutions of their firms. Indeed, CFOs should develop a more holistic approach and challenge their traditional standard corporate profitability measurement as highlighted in the graph below:

In this approach, one should determine that the overall cost structure is adequately sized with current levels of revenues generated while at the same time ensuring that each product is properly priced for each customer and that each client's overall profitability is appropriately distributed.

Corporate profitability analysis. For every corporation, it is crucially important to have an overall consolidated view of all the sources of income and costs in order to take effective action against major inefficiencies easy to capture at the consolidated level. This method helps the CFO to analyze all the different costs by their nature and compare them with underlying activity and profitability figures. This could also allow firms to better benchmark themselves with their competitors.
From this approach, corporations may for example outline that abnormally high tax charges are currently paid and might seek new ways to optimize their tax expenses.

In-depth analysis of financial or legal provisions at the consolidated level may also uncover issues or concerns about internal auditing systems, which can be further structured in order to optimize the long-term profitability of the firm by reducing levels of risks and of future provisions.

Figure: The three dimensions of firm profitability



On the other hand, insufficient investment costs may, for example, outline a slow deterioration of the firm's long-term competitiveness on its market (i.e., low R&D or preventive maintenance levels).

A strong understanding of current and full capacity levels is also key: in most fixed cost intensive businesses with under-usage of their current capacity, gaining new clients will most likely increase profitability associated with actual clients, while improving the profitability of the whole firm. In the retail-banking industry for example, strategies focusing on boosting sales in branches where the capacity utilization is lower may increase the overall revenue quickly while maintaining the current level of costs.

Overall, marginal and incremental profitability analyses should be conducted alongside traditional full profitability analyses in order to identify potential opportunities to enhance total profitability by increasing revenues, allocating fixed costs in a more efficient way, and performing economies of scale.

Product profitability assessment. At the level of each business unit, it is key to understand product cost structures in order to ensure that CFOs have an accurate view of their profitability levels in a dynamic environment at each stage of product life cycles.

Indeed, finance leaders should be involved from the product design phase in order to help designers to correctly assess the different costs associated with new products. Ongoing measurement of product profitability in latter stages shall also be conducted in order to ensure that the initial profit target is met.

Identifying each product's cost structure will also lead to better pricing and reinforce the firm's ability to better align its revenues with its cost drivers. As a matter of example, in the asset servicing industry, administrators used to apply fees according to the fund's assets, regardless of the size of the fund.

This method was not taking into account the fixed costs incurred during the day-to-day activity (Fund Net Asset value calculation, etc.). However, the Madoff crisis in 2008 led to a significant drop in the amount of assets managed, and the revenues produced were not sufficient to cover actual fixed costs. Subsequently, administrators added fixed fees in order to cover the fixed costs and to minimize the effects of the crisis.

Client profitability measurement. Still at the level of the business unit, once finance teams determined sales at granular levels and profitability at the product level, profitability at the client level can easily be determined with simple financial models:

- Revenues are identified through invoices paid
- Costs can be simulated using a client's total sales volume for each product and total cost per product (as explained in the previous section)

This approach will enable the management team to determine which customer segment is driving the business unit profitability and will help solve simple questions such as: is the profitability of clients from a specific sector outperforming the average profitability of other clients? Are margins evenly distributed among the different customers? Are margins greater on smaller or larger customers? What is the impact of commercial gestures on the client profitability? Does the pricing applied to the client effectively cover the operated activities (in some cases, clients have been asking for additional services which did not lead to price adjustments)?

Client profitability measurement exercises should also be conducted at the consolidated level in order to quantify the total exposure of the corporation to any specific client. The combined use of business unit and consolidated client profitability measurements should help to better tailor client-specific marketing strategies at the corporate level and maximize total profitability at the client level while minimizing risks of losing important customers.

The following table provides examples on possible axes for reflection and action on costs and revenue parts of the analysis:

	Revenue improvement initiatives	Cost reduction initiatives
Corporate level	• Determine if the corporation can onboard new clients without increasing its fixed costs or recruit new staff (i.e., are economies of scales possible?) • Assess the effects of taxation on the overall profit	• Assess whether indirect costs associated with specific activities can be outsourced in order to improve overall profitability • Centralize administrative and support functions in order to enhance operational efficiency and reduce specific types of costs
Product level	• Revisit the pricing on specific product lines, if this one does not cover the costs • Develop marketing campaigns/distribution channels to boost sales of products if volumes do not meet target levels	• Automate processes • Reduce the range of products offered by discontinuing non-profitable products or segments
Client level	• Renegotiate contracts or fee schedules with low-margin customers • Accept commercial gesture requested by clients • Refocus activity on the most profitable clients • Increase cross-selling and upselling initiatives to counterbalance low-margin products • Accompany high-margin clients on new markets	• Propose clients to standardize some products which require specific processes, generating an extra layer of costs • Review the service offering by reducing costs and increasing the client focus

The implementation of such approaches has allowed many fast growing companies to structure their financial planning and reporting functions in order to better structure their corporations and to keep their costs under control. This also improved their future perspectives by developing more targeted revenue analyses at the client and product level and helped them to shape and structure their strategy. This point is key for maturing companies in order to adapt themselves and better manage their costs and resources to overcome their transition phase and support future growth.

Step 3. Taking action: build an action plan and create an appropriate governance framework to optimize business performance

Once clear ways of profit improvement are identified, corporations must determine key initiatives to implement with a realistic plan that will get results quickly while improving long-term efficiency. As soon as new strategic guidance is established, corporations will need to ensure that projects are monitored properly and that appropriate resources are deployed in order to meet new targets.

10 Key Success Factors for CFOs to succeed in a competitive business world

1 Rely on strong accounting systems and mature P&L reporting tools to gather reliable data

2 Review reporting accuracy and hypotheses periodically

3 Keep it simple: do not over-spend time on building complex financial models

4 Set up a proper governance with the different divisions involved to generate reliable profitability figures, to agree on and monitor future corrective actions

5 Benchmark performance with successful competitors

6 Encourage the management team to go from general to more targeted strategic decisions by providing them with more specific analyses

7 Actively review and communicate on key priorities and achievements

8 Seek and identify quick wins

9 Involve business leaders from cross-functional teams and provide them with insightful reports

10 Leverage on successful initiatives to spread them on a firm-wide basis and promote the share of knowledge within and beyond finance teams