Deloitte.

CFO Insights
Pricing for profitability: What's in your pocket?

CFOs have long been confident in their ability to affect the cost side of the margin equation. But with multiple layers of overhead wrung out of the system and product costs rising unabated, unlocking the price side has taken on a certain sense of urgency.

Effectively implementing a pricing strategy, however, is more than simply viewing products on a cost-plus basis. It is also more than tracking pricing performance at the aggregate level. Instead, the promise of pricing is in the details: an effective strategy should rely on understanding economic profitability at the customer, product, and segment level—the so-called pocket margin—and using that information to inform overall decision-making.

To get to that level of detail, though, may require overcoming cultural, data, and compensation barriers to determine pocket costs. The effort is worth it, however: research has shown that pricing has up to four times more impact on profitability than other improvements.[1] In this issue of *CFO Insights*, we'll look at the power of understanding pricing at the customer level and discuss ways to install pricing disciplines that deliver consistent, positive results.

What are pocket margins?

Clearly, finance chiefs recognize the power of pricing. In the Q2 2012 *CFO Signals*™ survey, three-fourths of CFOs reported that their finance organizations were at least moderately involved in tracking and reporting pricing performance and profitability.[2] In addition, more than half reported substantial involvement in aligning pricing strategies with corporate strategies, managing exceptions to general policies, and setting pricing based on data and analytics.[3]

It's also clear that finance chiefs are not afraid to wield the pricing baton. That same survey found that 65% of CFOs reported having raised prices, and 42% said more increases were coming. [4] Still, how they raised prices was not totally apparent, and when it came to profitability analyses, customer-level profitability was comparatively less utilized and influential than, say, geography-level profitability analysis.[5]

But it is the customer-level *economic profitability* that can offer an untapped reservoir of information—and potential for improved margins. For example, which customer segments are being given unwarranted volume discounts; which are unaffected by slight price increases; and where are delivery promises being made that materially increase transaction cost, but are not charged for? To get at that level of information, however, may require moving past the aggregate view of pricing (gross margin, net margin) that finance typically demands to the "pocket" view that takes into account everything from payment terms to freight costs in order to identify the true profitability of a transaction (that is, gross margin less detailed allocations of fixed costs and SG&A). And from that information, CFOs can extrapolate how profitable individual products, customers, and channels are and inform decisions that include, but are not limited to:

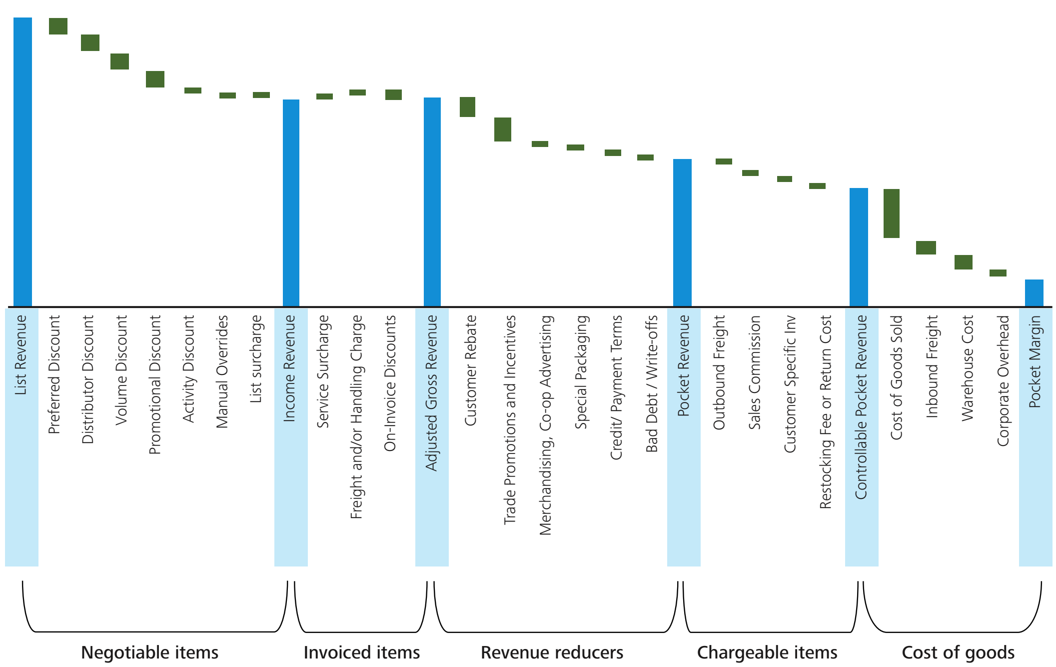
- What price premiums should be associated with products that significantly impact working capital?
- On a regional level, how should we assess and adjust our product portfolio based on geographic dynamics?
- Instead of subsegmenting the market with multiple products, are there loss leaders that can be cut from our portfolio?
- Is discounting being used by our sales force uniformly across the board, or in a strategic way with our best customers?
- Are there ways to use the pocket cost information to effectively increase prices without losing customers?
- Are we waiving our fee policies on low gross margin transactions and simply breaking even?

Identifying and leveraging pocket information

While the analytic tools exist to identify costs at a pocket level, the data is often widespread and incomplete, and frequently siloed. Sales executives typically worry about revenue and the commissions associated with it; supply-chain professionals care about containing fuel and other factors; manufacturing wants the lowest unit costs; marketing focuses on which discount campaign to offer next; and all are concerned with optimizing their particular piece of a product's life cycle.

But to fully assess pocket costs, finance should identify the components that add or subtract value from the business on a marginal basis. Those include factors that are not part of cost of goods sold (COGS), such as expedited shipping, fixed-asset or fixed-cost productivity, the cost of capital included in payment terms, and the various discounts and promotions offered. And one effective tool to identify those factors is the price waterfall (see Figure 1). Working backwards from the list price, CFOs can use the tool to identify margin leakages and create visibility from a reference list price down to the pocket margin, including discounts, rebates, and other cost elements.

Figure 1. Where the leakages are: An illustrative price waterfall



Source: Deloitte Consulting LLP

Moreover, the visual representation makes comparison with competitors very easy—and offers convincing proof of where price erodes in the multiple steps between making and delivering a product.

Such an exercise also allows finance to match revenue and costs for individual transactions. While a product that earns 40% margin may look like the a winner in the product portfolio, if it turns out to be highly engineered and highly specialized, and requires extra sales support, it may not be. Instead, it may be the product that earns 20% margin and only has to be packed and shipped that you should be expanding. Knowing what your costs are going forward may allow you to make the decisions that fit into the overall product strategy and build economic models that:

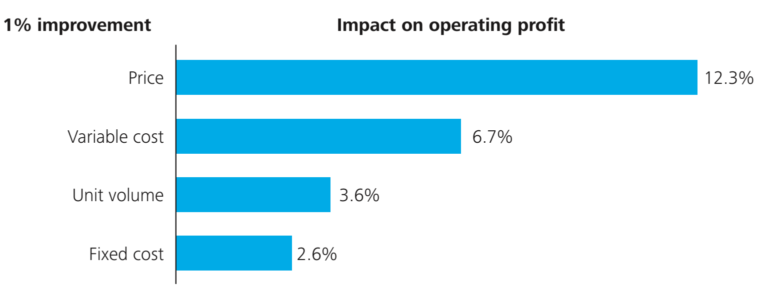
a. **Affect strategy.** By making sure everyone involved in the pricing equation has a proper understanding of the economics of the business, CFOs can influence not just pricing policies, but overall business strategy.

b. **Educate stakeholders.** Having pocket-margin information can allow a CFO to educate his or her peers, CEO, and the board about pricing policies that work. If, for example, the data shows that the sales and marketing are pushing pricing strategies that sell products that don’t contribute to the overall value of the business, those policies can be adjusted.

c. **Institute controls.** One outcome of pocket costing is often the exposure of “unwarranted discounting”—awarding discounts to customers whose volumes do not justify such action. One solution is to put limits on who can discount to what level and assign a finance person to authorize discounts that exceed that level.

d. **Create a single version of the truth.** Pocket costing exposes which products or customers are contributing value and which are not. That single version of the truth also allows individual functions to make decisions about resource deployment, such as where distribution centers should be located, how much product should be kept in inventory, and how goods should be delivered.

Figure 2. Pricing has 3-4 times the effect on profitability than other improvements



Source: Compustat, Deloitte Analysis
Note: Impact estimate is based on the average *Fortune* 1000 company

Five questions for your pricing manager

For CFOs, acquiring and leveraging pocket-pricing information should start with a series of questions for their designated pricing managers. Specifically:

1. **Who are our most profitable customers according to the sales force? According to finance?** Evaluating profitability may be a very different process depending on who is doing the evaluating. While the sales force may be enamored with a particular customer based on sheer volume, you may be barely breaking even on that customer after selling and servicing costs are taken into consideration. Armed with customer-profitability information, however, a CFO can figure out where unwarranted discounts are being given or where special handling may be inflating costs. It also gives CFOs the profitability data to reassess which customers can be offered discounts and which can’t.

2. **What are our transaction patterns, and what do they tell us?** Transactions over time speak volumes. Take a customer with average gross margins of, say, 40% that has a large portion of annual transactions under $100. If it costs $20 on average just to deliver the goods, and sales is offering free delivery on these small orders, it becomes very difficult to conclude that the revenue stream is profitable. Gaining visibility into such margin erosion can allow a CFO to challenge strategic decisions, such as offering daily deliveries, or at least explore the option of going back to the customer to renegotiate terms so both parties win.

3. **How do we allocate pocket costs in determining price?** Often in making pricing decisions, it is not readily apparent how to allocate pocket costs. What we typically observe is a smooth distribution of those costs. So while at an aggregate level everything may appear profitable, in reality most companies have winners and losers—they just don't know which is which. CFOs should develop a better policy for allocations in order to make better pricing choices.

4. **Do we have the analytical talent to accurately decipher pocket margins?** These days, it is essential to have finance staff, particularly in finance, planning, and analysis (FP&A), who can analyze pricing-trends data by geography, customer profile, product line, and other dimensions. As in other areas of finance, however, such specialized analytical knowledge is in short supply, and CFOs need to figure out how to build that capability either by developing talent in-house or hiring from outside. In this case, CFOs should also be open to developing someone from sales or marketing who is knowledgeable about individual customer pricing information. The point is that accounting knowledge is insufficient in this case—you need someone who has some operational knowledge to attain a better allocation of costs.

5. **Do our compensation practices help or hinder our pricing strategy?** Since sales and marketing professionals are often compensated differently, it can lead to pricing decisions that do not create value. For example, if sales executives are paid commissions on revenue or gross profit, they often don't care if the company charges for hazmat or has a large safety inventory. None of that shows up in gross profit, but it does affect overall financial performance. For CFOs, aligning the compensation plan with pricing and profitability objectives takes a true understanding of the economics of the business, so the rewards offered are aligned and are commensurate with the goals of the business.

Out-of-pocket benefits

To adequately price in today's competitive marketplace, finance should build economic models that maximize sale-by-sale profit. Central to creating those models is a granular understanding of customer analytics on a product-by-product basis.

The companywide deployment of such information can help clear the way for informed decisions about everything from channels and products to sales and advertising. In addition, once a company has an understanding of the impact on individual products and customers, that information can offer a window into other areas of operations, such as the proper levels of safety stock and the cost-effective delivery methods.

Finally, gaining a handle on pocket margins can give CFOs another tool for growth and allows them to further drive the alignment of pricing approaches with corporate strategies. Pricing, after all, can expand earnings faster than cost cutting.

What's in your pocket?

Endnotes

[1] Compustat, Deloitte Consulting LLP, 2009.

[2] *CFO Signals*, Deloitte U.S. CFO Program, see 2Q2012.

[3] *CFO Signals*, Deloitte U.S. CFO Program, see 2Q2012.

[4] *CFO Signals*, Deloitte U.S. CFO Program, see 2Q2012.

[5] *CFO Signals*, Deloitte U.S. CFO Program, see 2Q2012.

Primary Contacts

Richard Hayes
Principal
Deloitte Consulting LLP
richayes@deloitte.com

Ranjit Singh
Principal
Deloitte Consulting LLP
ransingh@deloitte.com

Deloitte *CFO Insights* are developed with the guidance of Dr. Ajit Kambil, Global Research Director, CFO Program, Deloitte LLP; and Lori Calabro, Senior Manager, CFO Education & Events, Deloitte LLP.

About Deloitte's CFO Program

The CFO Program brings together a multidisciplinary team of Deloitte leaders and subject matter specialists to help CFOs stay ahead in the face of growing challenges and demands. The Program harnesses our organization's broad capabilities to deliver forward thinking and fresh insights for every stage of a CFO's career – helping CFOs manage the complexities of their roles, tackle their company's most compelling challenges, and adapt to strategic shifts in the market.

For more information about Deloitte's CFO Program, visit our website at: www.deloitte.com/us/thecfoprogram.