Costing and profitability management: Unlocking business insights for competitive advantage
Leading organizations today are at varying levels of ERP maturity. While Fortune 500 and other large companies have made immense investments in enterprise data and are ahead of the curve in fulfilling operational capabilities, there still exists a large gap in truly capitalizing on the gains of data availability and processing capabilities. This situation is only aggravated in many modest-sized firms. Costing and profitability management (CPM) is one area where such vital information can be leveraged to create further value, as well as operational efficiencies.

In addition to ERP maturity, the rise of automation and robotics has brought forth a world of big data sources and a degree of accuracy that can augment existing sources of finance, supply chain and procurement, marketing and product planning, and operations data to help solve the next generation of costing and profitability challenges.

...there still exists a large gap in truly capitalizing on the gains of data availability and processing capabilities
The case for costing and profitability management

Business insight is created from the combining of disparate data to find meaningful information and an increased understanding of your operations, products, services, customers, and distribution channels. Enhanced insight through CPM can provide a competitive advantage for your business, enabling a low-level understanding of issues, identification of opportunities, and giving you greater in-depth insight into major mechanics related to your business. As companies grapple with lower top-line revenues, at least until consumer demand revives to prepanademic levels, a robust cost management strategy will be vital to driving profitability in a highly competitive, postpandemic global economy. Companies worldwide have been investing significantly into their ERP systems and other tools to achieve greater cost transparency and leverage insights from analytics reports to design better profitability strategies.

The example use cases highlighted below demonstrate the utility and benefits of analytics-driven costing strategies, and their effective implementation, related to helping drive profitability margins:

Enhanced insight through costing and profitability management could provide competitive advantage for your business

Figure 1. Example utility and benefits of analytics-driven costing strategies

- **Product and customer profitability**
  - Understanding product profitability enables the organization to allocate assets according to greatest return, as well as rationalize the offering portfolio.
  - Customer profitability identifies where investments should be made in customers and customer cohorts and helps in identifying growth opportunities.

- **Channel management**
  - Accurately measuring performance by respective distribution channels provides insights into profitability improvement opportunities through driving toward more effective outlets and rationalized incentives.

- **Cost management**
  - Exposes root causes for high-cost activities and directs the organization to take action and remedy.
  - Activity-based costing and proper allocations support calculating accurate conversion costs at a SKU level.

- **Tax and transfer pricing**
  - Effective CPM practices and tools enable automated transfer pricing policies, centralized tax administration allocation rules, and prebuilt traceability reporting capabilities.

- **Pricing and revenue strategy**
  - Informs product pricing decisions based on achievable profitability.
Additional key benefits of an effective CPM program

- Provides increased transparency and visibility to support effective decision-making. Information collected at the most granular level can be rolled up to provide greater insight into different dimensions, such as channel, market, customer, product, and vendor.

- Enables the ability to measure and cost unused capacity accurately. Fully allocated unit cost will rise as efficiency declines, with the root cause being reduced throughput, not increased cost.

- Better isolates key profit drivers and margin variance due to a different mix of products sold, independent of changes to product cost or price.

- Allows for comprehensive internal and external comparative analysis via unit cost benchmarking.

- Increases efficiency, transparency, and dependability of transfer pricing processes.

- Creates a culture of accountability with end-to-end transparency of costs incurred by a product line or group, and a single version of the truth.
Key components of an effective CPM program

**High-quality data sourcing**

In addition to ERP systems and other CPM software solutions, organizations are increasingly focused on understanding underlying data structure and data flows. As organizations strive to model complex allocation processes for more accurate visibility into profitability metrics, expanding data sources and volumes are uncovered. Merging and harmonizing large data volumes from disparate sources, as well as implementing analytics and visualization tools, creates additional challenges, such as precision and accuracy of data.

Handling large volumes of data in a secure environment has, historically, been challenging and costly. Sourcing this data for allocation models involves reaching across multiple business units and functions in the organization to collect data, rates, and rules. This necessitates more significant time and effort spent on data quality maintenance, since the accuracy and quality of sourced data can be a major driver of the accuracy of allocation models, as well as the analytical insights and business decisions derived from the output.

Modern data management designs for cost allocation models link product, service, and customer transactional attributes to financial data. Maintenance and monitoring of source data quality become paramount to ensure that model integrity is preserved. For example, to accurately calculate product line profitability, there should be data around quality issues, and resulting rework costs, of each of the SKUs within a product line. If this data source is inconsistent, the resulting costing measurement will be inaccurate. In order to overcome data deficiencies and help ensure consistent measurement, either the source data will need to be improved or more rigorous transformation and modeling will be required.

As companies move into the digital era of IoT, data collection and sourcing will play a pivotal role in how organizations leverage data to drive their cost allocation models.

At the end of the day, it is the linking of the cost pool to effectively sourced allocation drivers that determines optimal costing and profitability solution outcomes.

**Allocation methodology and execution**

Restructuring or upgrading an existing ERP, or migrating to a new one, usually gives rise to an allocation methodology change. Though profit and cost centers may be adequately predefined in an organization, there are cases where a simplification or standardization drive precedes any change. This eliminates any redundant cost or profit centers from the system. The company can then reassess the remaining cost centers and evaluate whether they fall into any mentioned categories.

Once the company has decided on the tool and provider (for example, Oracle PCM, Anaplan, etc.), rules can be precoded to perform desired calculations. The flexibility of the tool to distribute data across dimensions and attributes varies from tool to tool.

Effectively sourced driver data for allocation calculations for each dimension can be companies’ most effective catalysts for refining costing and profitability accuracy. Cost and profitability drivers are the metrics that explain how expenses and revenue are derived, their origin, and the levers that may be available to influence them. Allocation drivers are predefined rules within an organization that translate how a product or service will be charged out to each function, cost center, business unit, product grouping, or SKU, as examples.

For instance, in a case where a group manager may be driven by the objective to minimize charges and report profitable results, organizations may need to choose allocation drivers that are predefined and consistent across the organization so as not to unduly burden or benefit any individual business segment.

Beyond the mechanical implementation of an allocation methodology, reaching a consensus across organizational stakeholders can be a significant effort that requires dexterity in arbitration. Decisions made in how costs are allocated has a direct impact on the profitability of business segment owners. It is the implementation team's responsibility, as well as that of future CPM owners, to negotiate these challenges and reach common agreement across the organization.
Costing and profitability management: Unlocking business insights for competitive advantage

Reporting, analytics, and data-driven decision-making: Key metrics

The key component of any successful CPM program is providing stakeholders with analysis and reporting to aid effective decision-making. As with many reporting solutions, these could be visual, narrative, or financial in nature. Since allocated data volumes are usually large, many of the decisions could also be guided by algorithms and machine learning. An effective example of this would be SKU prices on e-commerce portals and bidding websites, where elasticity and price thresholds may be built into the algorithms.

Also, due to large allocated data volumes, and to support financial and management reporting, many effective solutions successfully utilize the built-in and self-serve reporting capabilities available in widely used CPM offerings, as well as those built particularly for performance and use over a database layer.

Agnostic of tools, an effective reporting strategy ties together the source cost pool data, drivers or allocation methodology, and post-allocated data for a synthesized view of the financial results.
Success stories

Insurance company

Business issue
The client was using several fragmented applications for its business transactions, consolidations, and reporting needs. The client’s objective was to minimize the amount of manual effort required, and it was keen to understand the allocation capabilities of the financial application. The organization was looking to improve current architecture and cost allocation processes to address its evolving needs.

Engagement scope and approach
The engagement encompassed the business requirements and design of an Oracle Profitability and Cost Management Cloud (PCMCS) solution. This design integrated the following allocation processes:

- Chargebacks
- Management reporting allocations
- Legal entity allocations
- Statutory and HIF allocations
- Commissions, taxes, and transfer pricing

The design scope included nine allocation data sources, more than 10 transfer pricing data sources, three drivers, and nine standard reports.

Value delivered and impact
The Oracle PCMCS solution helped improve the transparency and traceability of expenses and included flexibility to allocate expenses at different organization levels. In addition, the solution provided what-if modeling capabilities that would allow all users to create calculation models with various drivers.

Retail e-commerce company

Business issue
The client was using a time-consuming and manual allocation process that affected its ability to deliver quarterly management restatement reports. The client’s objective was to standardize its allocation approach (which required 20 different spreadsheet models at the time), minimize effort in maintaining those rules, and automate data loads centrally.

Engagement scope and approach
Deloitte facilitated the gathering of business requirements, leveraged Anaplan accelerators in a user-friendly design, and developed a robust model. The solution integrated the following:

- P&L expense line item allocations
- Restatement of pre- and post-allocated data based on proposed product hierarchy changes
- Allocation process traceability, auditability, and approval

Value delivered and impact
Working with the client, the Anaplan model helped facilitate:

- Replacement of 20 manual spreadsheet models
- Integration and automation of 25 driver data sources
- Standardized allocation engine for allocating P&L line items and facilitating contribution profit and management reporting
- Plan restatement post-product hierarchy reclassification in a changing business
- Centralized dashboards to manage allocations across multiple line items and process owners
Costing and profitability management: Unlocking business insights for competitive advantage

Engineering and consulting company

Business issue
The client, with annual revenue of more than $5 billion, engaged Deloitte to transform and automate its new transfer pricing process with the help of the Oracle Profitability and Cost Management (PCM) module and integration back to existing Oracle R12. The goals for the new system were to:

• Change to one global risk-based transfer pricing policy
• Move to a principal hub operating model, and simplify intercompany transaction activity
• Enable an automated monthly transfer pricing process to calculate, post, and analyze intercompany transaction activities
• Accommodate multicurrency processing within the solution, with extracts for reporting, analysis, data sources, and traceability

Engagement scope and approach
A new transfer pricing system was implemented using the combination of Oracle PCM and Oracle Integration Services to generate transfer pricing adjustments and intercompany transaction invoices in the format required for processing by Oracle R12.

Value delivered and impact
Implementation of the new integrated transfer pricing system, using Oracle PCM, led to the following benefits:

• A 95% reduction in monthly invoice volume
• Estimated benefit of approximately $30 million in future cash tax impact
• Reduction in the overall effective tax rate, tax compliance costs, and tax audit exposure
• Compliance with global documentation and transfer pricing studies
• Elimination of large year-end adjustments and reduced foreign exchange exposure

In the current environment, the need for the utmost visibility into a business’s true operating nature is more critical than ever. Having a clear understanding of cost drivers, impact on profitability, and high-value customers can enable organizations to navigate these uncertain times and position themselves to come out stronger.

Looking to mature or transform your costing and profitability management capabilities? Contact us.

Raj Chhabra
Managing director | Finance & Enterprise Performance
Deloitte Consulting LLP
Tel/Direct: +1 313 396 5919
Email: rchhabra@deloitte.com

Srini Chinnam
Specialist leader | Finance & Enterprise Performance
Deloitte Consulting LLP
Tel/Direct: +1 412 402 2854
Email: schinnam@deloitte.com

Brent Heath
Specialist leader | Finance & Enterprise Performance
Deloitte Consulting LLP
Tel/Direct: +1 713 331 4444
Email: bheath@deloitte.com
As used in this document, “Deloitte” means Deloitte Consulting LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

Copyright © 2021 Deloitte Development LLC. All rights reserved.