

## Delivering Profitability: A Consultant's View

DRAFT Seeking Feedback: July 15, 2011

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### Sitting on a whale fishing for minnows<sup>1</sup>

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If you are like most business executives, you are in one of three camps:

- 1) Constantly on the lookout for opportunities to increase net income
- 2) "Sitting on a whale fishing for minnows"<sup>2</sup>
- 3) Happy just to have your job and that no one is complaining to loudly and don't want to rock the boat.

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<sup>1</sup> Joseph Campbell, The Power of Myths, 1988

<sup>2</sup> Joseph Campbell, The Power of Myths, 1988

If you're in the first camp, you've likely already pulled all the levers you know and need to find some new ones. If you're in the second category, you probably want to find a lever which will help you make some incremental improvement without being too risky. And yes, even if you are willing to admit you are in the third category, it might be a good idea to have one or two ideas in your back pocket just in case the Board of Directors, your senior executive or your business partner decided good enough just isn't any more. The tricky part is knowing which levers to pull and having the time to pull it all together in a way that's compelling for those who may need to approve the changes necessary to produce the desired results.

What are the main things a business executive should consider in this situation?

Knowing where to look and how to think about profitability can both help identify the opportunities and save precious time and effort in delivering solutions. While every aspect of a business can impact profitability, the first things to consider are the basic financial building blocks and key drivers of profitability. At the most basic level, profitability is driven by total revenues minus total expenses. While that is obvious to most business people, the basics are a good starting point. You might or might not be surprised by how often even very very large businesses make critical mistakes by not looking at the basics. One of my managers started every major meeting by holding up a football and stating as Vince Lombardi did before every football game "This is a Football" keeping players focused on why they were there and the most fundamental element in the game.

Given that there are many complexities in how to increase profitability; it makes sense to have a good understanding of the overall business and the key drivers of profitability, both in revenue and expense and to make sure the business isn't hitting up against a fundamental business model challenge.

I have seen companies trying to solve a business model challenge by cutting expenses and trying to solve an expense problem by increasing sales. In the first case, the company kept cutting and then rehiring staff, failing to understand that without changing the business model their efforts are doomed to fail. In the second case, a major bank kept raising sales incentives and putting pressure on branch staff to sell more of an insurance product that wasn't covering its purely variable expenses. The more they sold and the more they raised incentives the more unprofitable the business unit became as the senior executive in charge of the unit became increasingly adamant that they must sell more, while also gently blaming the branch channel management for his products not being profitable.

Likewise I've seen companies sacrifice quality of product to save pennies and I've seen companies increase prices which were not justified. While there is a market for companies who master saving the most pennies and becoming the cheapest provider, this strategy typically requires massive scale and even these very large companies are at risk of losing customers to a competitor who does things better. In most cases the companies which reduce quality or raise prices which are not justified negatively impacted long-term profitability by losing highly profitable customers. Driving profitability is not simply about cutting costs or raising prices, it's about making smart, educated, well-researched decisions based on a solid foundation of information and business insights.

## The Anatomy of a Profitability Project

So how does a business executive avoid the pitfalls and successfully launch a profitability project?

Start with a big picture and a high level understanding of the business, including any material changes in its operating environment.

For smaller businesses it typically makes sense to start with a very broad view of the business, including business strategy, and then determine which of the drivers are likely to have the greatest opportunity. In a small business, typically any and all aspects of the business can be changed fairly easily, and the small business owner has incentive to make the changes.

For larger businesses there may be opportunities across a number of drivers, but for various reasons it often make sense to drill deep just in one driver of profitability or, perhaps, a few closely related drivers.

One of the first challenges in determining next steps within a profitability project is to determine what method (s) of review to use to produce the desired results. Also it's important to understand many of these variables interact and overlap with other drivers of profitability. In fact often some of the greatest opportunities a consultant finds are in the gray area between two functions, where both functions look at a specific type of opportunity but neither function looks at how the two impact one another. As a slightly complex example: real estate is often managed in a sourcing or purchasing function, human resources are managing people and their benefits and business units are pay the underlying expense and may be establishing performance systems. Despite numerous studies which show the value of well structured flexible working arrangements, most business can't see the value as each group (sourcing, HR and the Business Unit) are each only seeing one part of the total picture. In the worst cases each group worked independently and rolls out a program which only serves one of the constituents and it ends up costing the business money. For example: HR will roll out a work from home program as an employee benefit without considering how to establish performance systems and business processes which support cost efficiency. An all too common outcome is the business unit either notices costs rising or ends up with a performance issue and turn off the program.

Profitability can be positively impacted by better understanding the following key profit drivers and their interplay with one another:



Business Plan 2011 - 2016



### 1. Business Strategy

Broadly defined strategy both defines and communicates what the business is about, where it is heading and how the business managers plan to achieve their vision. When done well, it helps guide the teams of people both within the company and those who provide services to the company. It defines what is of highest importance, what's not, and ideally provides a high level road map for management's plans to pursue and to achieve its aspirations.

Strategy is at the core of profitability. Strategy which is too widely defined can be overly expensive to execute and strategy which is too narrowly defined can cost revenue. Likewise operating a business inconsistent with its strategy is likewise to either waste resources or miss customer opportunities. For example: If the strategy is to win customers through lowest cost, then the company should seek processes, structures, and methods of delivering services consistent with being the lowest cost provider. By contrast a company, which defines its strategy as providing the highest quality customer experience, should expect to spend more resources on the quality of its staff, investments in innovation and understanding its customers.

- directors expectations and direction guidance
- provides context to inform stakeholder and provides a framework from within which decisions should conform
- limits or drives opportunities for improvement and therefore becomes part of the fundamental solution
- consistency in communication and execution
- must be effectively executed
- tactical plan to achieve strategic objectives
- competition
- strengths, weaknesses, opportunities and threats
- may include alternatives to organic growth strategies such as mergers, acquisitions or divestitures

## 2. Customers



**The best way to loss a customer, keep them satisfied.**

Satisfaction is over rated. Keep your customers satisfied and they are only one click from finding a new service provider or a new product.

Customers are obviously a critical component of profitability. Without customers a business does not exist. When driving profitability, we need to have a much deeper understanding of first the business strategy and then the customers. Is the business model one which relies on many equally balanced customers in terms of sales and profitability or is it a model which relies on a few customers who produce the majority of revenue or profitability? Are customer revenues predictable and steady? How much does it cost to obtain new customers? How long do customers remain customers? Are customers advocates or are they simply customers because it is difficult to change provider?

In a reversal of traditional thinking, I saw one client literally run off thousands of customers only to see profits skyrocket. Whereas a few key profitable customers or customer segments can make a business, unprofitable customers can be extremely expensive and through their use of valuable resources may run off profitable customers.

- customer experience
- customer life cycle and onboarding (an ounce of prevention is worth a pound of cure)
- acquisition and channel strategy
- customer research understanding and markets
- customer value proposition & profitability analysis
- top 10%, top quartile, bottom, 10%, bottom quartile analysis & trending
- customer strategy
- customers and their interaction with the competition
- longevity of customers and turnover

### **3. Human Resources & Organizational Structure [\[Add an organization chart\]](#)**

Its cliché to read “employees are our greatest asset” or similar thoughts within strategic documents of companies large and small . . . and yet most businesses struggle to consistently achieve high satisfaction from their employees and with their employees. Employee engagement is often the difference between an energized growth company and a company which struggles to survive. Employees impact everything from the cost to deliver products and services to the customer’s satisfaction with the products, services and the company itself.

- Directors, management and employee compensation and incentives
- employee engagement, productivity and turnover
- shared services organizations
- employee performance
- flexible employee working arrangements

#### 4. **Product Profitability**

While larger businesses tend to think more about product profitability, the concept applies to all products and all businesses. The analysis of product profitability can be very detailed in understanding product strategy, product costs, product fit and relevance within company, product pricing, customer impression of the product, customer demand etc. In many ways the product analysis can mirror the same types of analysis we do at the company level but with a concentrated focus upon a simple product or group of products.

- product strategy
- investing in the products
- loss leaders with cross sell monitoring
- modifying the products
- divesting or terminating the product
- analyzing the product revenue
- reviewing the product expense
- product pricing
  - i. the company's ability to attract and retain customers
  - ii. product margin and profitability
  - iii. market pricing
  - iv. value pricing
  - v. cost plus

#### 5. **Business Unit Profitability**

Business unit profitability tends to apply more to larger companies running many divisions or units. A few units or business lines may produce the majority of the enterprises total profitability. When reviewing business unit profitability, consider not only the basics but also the strategic importance of a business unit, how the business unit impacts other parts of the business in their ability to deliver, the impact of the enterprises fixed expenses and the underlying fundamentals of business within the context of the enterprise.

- benchmarking internally and analyzing best practices
- understanding variations and practices in both top performing and low performing business units
- identifying opportunities within each business unit and potential for shared services across business units
- Expenses unit to business unit and those shared across the enterprise

## 6. Geographic or Location/Branch/Channel Profitability

Location, location, location. Not only is the specific location of a business often a critical factor in its profitability and sales, but also variations between management style, geographic differences in customer preference, and variations in expenses and volume of purchase by location can all be important drivers in profitability. Likewise, channels including not only traditional brick and mortar but also telephone, internet, mobile devices etc. all typically have different cost structures and varying customer demand and often competitive pricing attributes. Two key considerations in channel include both the customer demand / value of channel and also the channels cost or revenue characteristics.

As a classic channel example, banks took a high cost branch channel, introduced a lower cost ATM channel and then found customers demanding both which in the near term increased costs. However, over longer time periods many banks have been able to reduce direct branch costs and enabled non-customers as an ATM revenue source. And in a few exceptional cases banks have effectively used the ATM as a competitive differentiator to attract customers.

- internal benchmarking and best practice analysis
- understanding variations and practices in both top performing and low performing locations, channels, etc
- location profitability analysis
- channel attribute analysis (profitability, customer loyalty, differentiator etc.)
- regional discounting or premium (pricing, purchases etc.)

## 7. Business Operations and Business Processes

Fundamental business operations and business processes impact the company's ability to deliver high quality products and services in a timely fashion. Operational and process efficiency can also be major cost drivers as labor in most businesses is either the largest or one of one of the largest expenses. As a word of caution, one of my favorite quotes from a previous manager of mine was "Anyone can manage a business to break-even. That is zero".

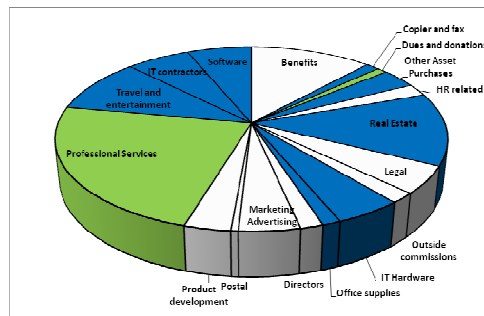
- operating efficiency
- process efficiency (lapse time, resource time, resources used)
- customer experience and speed
- quality and error rates
- business efficiency
- program office and project management
- employee satisfaction

## 8. Key Expense Drivers: Salaries, Occupancy, Technology, Cost of Materials etc [ might be a good place for a chart showing SG&A expense]

Key expense drivers is a specific drill down into transaction level expenses. Often these projects focus on Selling, General and Administrative (SG&A) Expense Categories. The projects may focus both on specific line items and upon understanding purchasing processes such as strategic sourcing expense categories, reviewing vendor agreements, understanding expense volume drivers, auditing the accounts payable files with a focus on tactical opportunities to minimize expenses without impacting quality of purchases or services delivered

- volume of item(s) consumed or wasted
- rate paid for item(s)
- invoicing errors
- contractual errors or miss billing
- duplicate payments
- accounting and expense classifications
- fraud
- best match purchase quality, demand and pricing
- volume discounts

## 9. Vendor expenses/purchasing / procurement / strategic sourcing process



Similar to the expense driver review in its focus upon external spending, these reviews focus upon the systematic process to achieve lower expenses for similar quality purchases

- logical of company guidelines in achieving desired results
- process for sourcing and procuring products and services
- quality of decision outcome
- quality of vendor relationships
- rate paid for quality received
- accuracy of process
- process efficiency and speed of decisions
- internal compliance with procurement processes and company guidelines
- vendor compliance with contracts

## 10. Taxes Paid including Business Income, Property and Sales Tax

Taxes are often overlooked in expense review projects simply because they seem “fixed”. Management often assumes nothing can be done and the tax department has already done what can be done to save taxes. However, often through no fault of the tax department, the taxes may be prepared correctly, but could be impacted by business decisions. Reviewing the business decisions can materially impact taxes paid. In other cases the tax department doesn't have the authority or knowledge to review taxes considered outside their domain. These include taxes like state and local sales taxes. Many companies mistakenly assume these are properly assessed and collected by their vendors.

- basis for tax including volume driver
- rate paid
- process for payment
- product specific tax
- tax and accounting classifications
- vendor, category and geographic tax analysis
- business decisions impacting tax rates

## 11. Financial or Resource Leakages

Financial or resource leakages can include traditional categories of waste such as stolen, volume of expired or out of date items, and may also include items such as inconsistent financial policies or financial policies which cost the company revenue or expense. As one example a financial institution limited lines of credit for all customers including their targeted wealthy client base to \$5,000. The policy didn't work for customers, cost the bank customers and potential revenue and made lines of credit excessively expensive to process for the size of the loan realized. In another case automated fees charged by the processing system which were waived by branch staff the day the fees occurred were never recorded in the general ledger. The CFO was shocked to find out the branch staff were waiving fees equal to over 50% of the bank's annual net income each year and in many cases the employees were waiving more fees than their annual salary.

- shrinkage
- inefficiency
- product and service give away
- financial policies
- lack of oversight, lack of time, and organizational or management gaps
- program and project optimization and project and program management
- hidden leakages

## **12. Financial management processes, such as budgeting, planning, capital allocation and treasury functions.**

Financial management processes are intended to foster good financial decisions for a company; however, all too often policies are archaic and have not been reviewed to keep pace with the current business model and current environment. In some industries, mergers and other significant change, is the normal operating environment and yet the businesses are run as if these don't occur causing a huge waste of resources and projects start and stop with regular frequency making the tracking of results achieved vs projections nearly impossible and inspiring little accountability.

- method for determining investment decision
- use of funds
- costs related to investing
- financing and raising capital
- method for allocating resources among business lines, products, customers, geographies etc
- program management consistence and review of results produced
- impact on budgets and expenditures of business disruptions such as mergers

## **13. Risk management and advanced financial topics including hedging and derivatives**

The most basic form of risk management most businesses of all sizes undertake is purchasing various forms of insurance ranging from the most basic property and casualty into commercial insurance policies which mitigate the companies risk and that of senior officers and directors. Risk management can be important both to current profitability and provide protection against future income.

While not commonly used at smaller companies larger companies also consider additional options for risk management including use of sophisticated financial products typically used to manage the risk of a future occurrence of an event which may be largely outside of the companies control but which may have a material impact on its operations. An example of this would be for the airline industry to buy a hedge against future changes in fuel prices. Given tickets for airline seats will have previously been sold at the time of the flight it's important for airlines to manage their costs to reflect their revenue per flight.

- risk management program
- commercial insurance
- hedging and derivatives
- regulatory risk management
- diversification: geographic, product, customers

#### 14. External variables including economic variables, regulators and regulatory environment

Interestingly as an economics major one might think, economic variables and external influences might be high on my list, but it took several persuasive emails from colleagues for me to warm to the idea of including these in the discussion on how managers might be able to improve profitability. Like me, I think many managers initially see these variables as largely external and beyond management. That is as things which happen to the business or are necessary evils that must be done as opposed to opportunities to improve profitability.

However, as these topics came into closer focus, discussions also brought to my attention the potential value which could be gained or lost if managers take a short sighted view and fail to embrace these variables for the competitive value they might provide. For example many companies comply with numerous regulatory requirements and simply account for them as a cost of doing business. However, best practice companies find ways to gain value and business insights from the information collected. As an example, one of the largest banks in the US was working upon its risk management framework and compliance with BASEL II, when they realized they were spending \$10's of millions to gather massive amounts of data and were only planning to use the information to check a box and comply with the requirements. Upon further consideration they astutely noticed the underlying information had huge value in how they managed their business. Thinking about how to capture value from the data not only produced direct benefit for the bank but also helped them in their thinking about the underlying business value in developing their framework and compliance with BASEL II. In another example a bank was simply developing a business plan to check a box for the regulators. The bank and the regulators found this approach didn't work as no-one had any real interest in developing a plan that might benefit the bank, its shareholders or employees.

- managing and mitigating external risks and variable including economic conditions, governmental factors, regulators and regulatory environment
- finding value in necessary exercises
- taking actions based on economic and other external variable
- helping customers manage risk

#### 15. Financial and Performance Measurement: "What gets measured, gets done"

While measurement may not see like a lever in profitability, measuring results can produce immediate results. The day after we revealed the volume of fee's being waived by branch staff a community bank client with about \$600,000 in total net income, held a meeting with all branch staff to let them know they were going to start monitoring the volume of branch fee waivers. Without any other changes the next day the volume of waives decreases dramatically. In fact as we looked back over the next few months and monitored fee waivers that single change produced over \$300,000 or a gain of 50% in Net income.

Not only can measurement actually produce results, measurement can be a predictor of future results and help mitigate risk and avoid future challenges. In a day with so much data available to management, the key is identifying those measures which are likely to produce the greatest positive impact for the business.

- Board of Directors and Management Score Cards
- Compensation Incentive Metrics at All Levels
- Performance Metrics and (ROE, ROI, Profitable Growth etc.)
- Volume Measures: Units Sold, Cost Per Unit, Margin, Spoilage, Days Work Lost, Error Rate, Employee Turnover, Training Hours Per Employee, Employee Engagement, Customer Engagement etc, etc.
- Trending Analysis: Customer, Product, Employee, Sales, Investments, and Investors etc.
- Leading and lagging indicators
- Predictive analytics

Over a series of articles or possibly in a book form, we will explore each of these driver and approaches to understanding profitability and help business executives understand what actions can be taken in each area to produce specific achievable quantifiable results.

