The Problem with Accounting

What's the difference between profits and profitability? In most companies, a net income deficiency of 30% or more. Let me explain.

Accounting information is at the core of virtually all of our business processes. It is axiomatic that accounting has two roles: providing financial information and providing management control information. The problem is that it is very good at the first role, and surprisingly poor at the second.

Financial accounting is critical to every business. The objective is to present an accurate picture of a company's overall performance – its profits. It grew up in the time of quill pens and arm garters, and its role is to tell shareholders how much their company earned. This discipline is well perfected and highly regulated. Just ask the Audit Committee of any public company.

The management control role is another story altogether. Even with an accurate financial accounting picture of overall profits, nearly every company is 30-40% unprofitable by any measure, and 20-30% provides all the reported profits and subsidizes the losses. In years of writing about this, no one has disagreed. How can this be?

This situation is a legacy of the prior Age of Mass Markets, when companies sought the economies of scale of mass production, coupled with mass distribution using arm's length customer relationships. In this context, more revenues really did mean more profits. Virtually all of our management information and processes were developed in this earlier era.

We now live in what I call "The Age of Precision Markets," in which companies form a variety of relationships with their customers – some very profitable, many not. Traditional accounting information is much too aggregated and broad for profitability management today. This is the underlying reason why almost every company has so much embedded unprofitability and why so many managers fail to identify and build their sustainably profitable core of business.

Instead, a transaction-based approach to developing management control information gives you the granularity you need to understand your profit picture, and to develop sharply targeted initiatives. I call this *profit mapping*.

Start by extracting a three- to four-month sample that includes every transaction (order line). The next step is to create what is essentially an "income statement" *for each transaction*, subtracting distribution, sales, and other operating costs from gross margin. You can do this at "70% accuracy" using available information and rules of thumb. Avoid lengthy debates about cost allocations, and sharpen your pencil later in the few places where better accuracy will matter.

Once you have this information, input it into a database program. In a few weeks, you can figure out precisely which products and customers are profitable, and what concrete steps you can take to improve things. Even in profitable customers, there are many unprofitable products, and vice versa. My forthcoming book gives several concrete examples of this.

This is very different from traditional “top-down” profit analysis, which focuses on the aggregate profitability of broad groups of products and customers – a process that derives directly from traditional financial accounting approaches.

The problem with accounting is that most managers simply assume that they can use the same process to develop accurate financial information and useful management control information. This is a big mistake.

Instead, if you develop an appropriate transaction-based analysis for management control, you can identify your profitability landscape and create the sharply targeted initiatives that will quickly increase your company’s profitability – and profits – both this year and for years to come.