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Making the CFO Chief Profitability Officer

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Companies suffer from "embedded unprofitability," says Jonathan Byrnes. Time for CFOs to build grassroots profitability management processes into their companies' core management activities.

by Jonathan Byrnes

"Who's Managing Profitability?"

This was the title of my first column in this *HBS Working Knowledge* series. I began the column with these words:

The most important issue facing most managers in this difficult economy is making more money from the existing business without costly new initiatives. In my research and work with companies ranging from distribution to telecom, I have been fascinated to find that at least 30 percent of each company's business by any measure (accounts, products, transactions) is unprofitable, but that this is offset by a few islands of high profitability. This sounds amazing, but it's true.

As I continued to write columns in this series, many readers sent me e-mails confirming that this was true in their companies. These companies ranged across a wide variety of industries and company sizes. In fact, I did not receive a single e-mail disputing my observation.

Over the past three and a half years, I've had an opportunity to talk to and work with executives in a number of companies, in both my research and consulting. Here, as well, my observation was almost always confirmed. The rare exceptions were companies in project-oriented businesses, like government contracting, that required project cost reporting, and a few privately owned companies that were willing to attack this issue.

Embedded unprofitability

How can a profitable company be 30-40 percent unprofitable? The answer is that overall profitability is an *average* measure of aggregate costs and revenues. However, even in very profitable companies, a careful analysis of the business at the grassroots level—using a technique I call profit mapping—reveals a characteristic pattern: 20-30 percent of the company's business is highly profitable, 30-40 percent is quite unprofitable, and the rest is marginal. In fact, the highly profitable portion not only provides all the reported profits, but cross-subsidizes the money-losing portion as well. (For an overview of how to create detailed profit maps in three to four months on a PC, see my column, "The Hunt for Profits.")

Even if all departments make budget, the company can still be 30-40 percent unprofitable. Why?

For example, when I ask groups of top supply chain executives whether all revenues in their companies are equally costly to serve, everyone agrees that the most effective way to rapidly increase supply chain productivity is to select business that fits the company's operating capabilities. They also agree that sales reps generally treat all revenues as equally desirable, regardless of the cost to serve. This lack of interdepartmental coordination is one of the prime causes of embedded unprofitability.

By contrast, Dell actively manages its demand to fit its supply, making adjustments several times per day. Dell's huge returns stem directly from this process of getting the details of the business right all the time. (See "Dell Manages Profitability, Not Inventory.")

Embedded unprofitability causes three big problems: (1) reported profits could rise, often double, by simply eliminating the unprofitable portion of the business; (2) the best customers generally receive only average service, which raises a critical risk of competitors picking off the profitable piece of the business by offering better service; and (3) the company loses the opportunity to shift resources to the highest payoff activities.

With the insights of a profit map, a company can secure its best business, focus on finding more of the best business, devise targeted measures to turn around the marginal business and parts of the unprofitable business, and steadily shed the residual unprofitable business. Not only is it very realistic to eliminate embedded unprofitability, but it generally costs almost nothing, and quickly generates large amounts of new profits and cash.

Barriers to profitability management

This poses a fundamental paradox. An enormous number of companies have large blocks of business that are unprofitable by any measure, and their managers agree that this is true. Yet, very few companies move aggressively to turn this around. Why not?

I probed this question in numerous conversations with CEOs, general managers, vice presidents, and CFOs over the past few years. Four essential barriers to effective profitability management emerge.

First, financial and management control information is not structured to surface the problem and opportunity areas. All departments have budgets. Sales has a revenue budget, and operations has a cost budget. However, even if all departments make budget, the company can still be 30-40 percent unprofitable. Why? Because virtually all budgets implicitly reflect historical business patterns, like "increase revenues by 12 percent," so massive areas of embedded unprofitability generally remain embedded, and largely invisible.

Second, everyone is doing something. Managers' projects range from product selection to cost reduction to market segment development. Most of these initiatives are useful to some degree, but they almost always miss the huge opportunity for systematic profitability impact that comes from getting the day-to-day activities of the business right all the time.

Third, paradoxically, there are strong investor pressures that appear to constrain top managers from turning around embedded unprofitability in public companies. Many managers are concerned that eliminating unprofitable blocks of business would require reducing revenues substantially, and this would hurt the company's stock price. By contrast, private company executives were very eager to improve profitability, even if it meant reducing revenues.

Fourth, in most companies, no one is responsible for systematically analyzing and improving profitability. This is an astonishing assertion. Yet, I have found that while virtually all executives are involved in activities to improve profitability, no one is responsible for systematically analyzing profitability on the micro level of accounts, products, orders, and services, and getting the details of the business right across functional boundaries to eliminate embedded unprofitability.

Certainly, a CEO or general manager is responsible for profitability, but most of these individuals are focused on major strategic initiatives, important customer relationships, and making sure their key managers make budget. The fundamental problem of analyzing the profitability of orders, accounts, products, and services, and improving them through precisely targeted measures, falls between the cracks in most companies.

What about CFOs? In my experience, virtually all CFOs are very focused on profitability in terms of meeting revenue and earnings targets. They are also involved in asset productivity initiatives, asking questions like, "Why do we spend so much money on payroll? Should we outsource?" And, of course, they are highly focused on managing cash, even to the point of acquiring or shedding divisions of the company to keep the cash flow in balance.

However, in my experience it is very unusual for a CFO to focus systematically on identifying and rectifying embedded unprofitability, and on building this process into the company's core set of ongoing management activities.

New CFO role

How can a company break this apparent logjam, and overcome these barriers to effective profitability management? The key is to define a powerful new role for the CFO: chief *profitability* officer.

This may seem like a strange suggestion, as virtually all CFOs view profitability as a central part of their existing jobs. But to be fully effective, CFOs must go beyond broad, departmental performance measures to build grassroots profitability management processes into their companies' core management activities. This task has three key components.

First and foremost, the effective CFO needs to develop a systematic understanding of the company's baseline profitability through profit mapping. This will reveal the precise areas of high profitability, of low profitability, and of negative profitability, going far beyond gross margins, market segments, and product families. This view will form the basis for laser-targeted initiatives to systematically improve profitability. Many of my columns in this series have addressed what I call profit levers, targeted ways to improve particular types of low performance situations, often at little cost.

Second, building a set of ongoing organizational processes for profitability management is a critical CFO job. This starts with integrating profit map information into day-to-day jobs throughout the company. For example, in my column, "Achieving Supply Chain Productivity," I offered this observation to supply chain managers: "If you work hard and achieve a 15 percent cost reduction on supply chain assets, and these assets are supporting unprofitable business, your job is not yet done." The same could be said of a sales rep who brings in a 20 percent revenue increase that actually *reduces* profitability.

The key to success is for the CFO to get his or her organization in front of the problem through integrated market planning. In this process, the sales and marketing groups join with the operations groups to define a set of account relationships, ranging from highly integrated to arm's length, and to target accounts for specific relationships. That way, the company's operating cost structure can be aligned in advance with the business mix. If this sounds like a tall order, it really is not. However, it is a different way of doing business, and leading companies have already seen great increases in profits and market share in this way.

Third, transition management will make or break profitability management initiatives in public companies. CFOs are right to be concerned about possible stock price repercussions from simply eliminating unprofitable revenues. However, many profit lever initiatives will increase profitability of marginal business at little cost, and with no revenue loss. Similarly, securing and growing your most profitable business, by shifting sales and service resources from unprofitable business, is only a matter of prioritization. Together, these can lead to major increases in revenues, profits, and cash flow.

For example, one auto accessory company that pursued this strategy actually increased its penetration of high-potential, low-penetrated accounts by over 40 percent within a few short months. At the same time, it created an agent network to service its marginal, low-potential accounts that were far from its depot network, reducing its costs and freeing up resources. Revenues shot up, costs dropped, and the company's stock price tripled in about three years.

The remaining issue is eliminating residual unprofitable revenues that can't be turned around. Here, the key is to have an orderly transition plan, bringing in new high-profit revenues as the unprofitable revenues are phased out through appropriate pricing. This requires good information, careful coordination, and sales quota adjustments.

Profitability management opens a new realm of opportunity for the creative CFO. Using it, a CFO can generate revenues, profits, and cash surprisingly quickly, and at very little cost. But it requires that the CFO move beyond his or her traditional domain, and become a central player in creating an effective culture of profitability that pervades the whole company. In this way, the effective CFO will become the company's chief profitability officer.

See you next month . . . here and at my Web site!

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