Strange Finance Problem: Too Much Accuracy

One of the biggest problems in effective profitability management is the instinctive desire on the part of many CFOs for too much accuracy. How can this be?

In my experience, there is good accuracy and bad accuracy. Let me explain.

Good Accuracy

Accuracy is essential for financial reporting, a prime CFO job.

I'm on the Audit Committee of a NYSE company, and we spend a lot of time making sure that the company's financial results are reported extremely accurately. Like all public companies, we have controls and audits to ensure that even inadvertent errors are uncovered and rectified. The SEC and other regulatory bodies take strong measures to enforce this requirement.

This need for strict accuracy in financial reporting shapes the culture of all Finance Departments. Most CFOs and other top finance managers have strong accounting backgrounds, and many have managed internal auditing departments.

This strong cultural bias causes two big problems in profitability management: (1) the overly rigid use of financial reporting information for granular profitability analysis, precisely because it is so accurate; and (2) an unfortunate insistence on a very high degree of accuracy in profitability management. Both get in the way of effectiveness.

Bad Accuracy

The first problem, using financial information for granular profitability management, seems counterintuitive. After all, great financial information is available and the company has worked hard to ensure its accuracy – why not use it?

The problem with simply using existing financial information is that it is compiled into categories that are much too broad for effectively managing profitability. Here's the acid test: if you select five accounts at random, and select five products at random in each of those accounts, would you know (or could you find out quickly) the profitability of each product in each account? In virtually all companies, the answer would be no.

This leads to the problematic situation of virtually all companies: 30-40% of the business is unprofitable by any measure, and 20-30% provides all the reported profits and subsidizes the losses. This results in a huge amount of embedded unprofitability in virtually every company – unmeasured, unseen, and untapped.

Why does this occur? Because revenues and costs are compiled into categories that work well for reporting the company's overall financial results, but are not granular enough to match revenues and costs on an invoice line basis. As a result, finance managers embark on a problematic exercise in allocating these accurately measured costs and revenues into broad

categories of account segments and product families – usually by using imprecise allocation functions.

All too often this becomes an exercise in trying to measure accurately things that can't be accurately measured. The objective implicitly becomes measurement itself, rather than clearly and relentlessly focusing the organization on discovering and acting on the most important profit opportunities.

Instead, you need a completely different process to develop effective granular profitability information. I call this process profit mapping. It involves essentially developing a 70% accurate "income statement" on *every invoice line*, then putting these into a database and sorting them by product, account, and other essential dimensions. I describe how to do profit mapping, and provide a number of concrete examples, in my book, *Islands of Profit in a Sea of Red Ink*.

The process takes an insightful manager and analyst about a month or two, using standard desktop tools.

It is critical to understand the important difference between information developed for financial reporting and information developed for management control. This is one of the basic distinctions drawn in introductory accounting and finance courses, yet it is deceptively easy to blend these together when the finance managers have already developed a huge amount of very accurate financial reporting information.

What is 70% accuracy?

Many top financial managers, particularly CFOs, have difficulty understanding the *need* to work with 70% accurate information for profitability management. They are so culturally accustomed to producing extremely accurate financial reporting information, that they tend to view 70% accurate information as merely the result of inadequately careful work.

Nothing could be further from the truth.

In order to understand the *needed* degree of accuracy for *granular* profitability management information (as opposed to accurate financial reporting profit information), you have to start by thinking carefully about what managers throughout the company will do with the information. Then you work back to the nature of the information that will be most helpful to them.

The first set of actions that managers will take with a set of granular profitability information is to quickly see where the business is making money, where it is losing it, and why – its islands of profit and sea of red ink.

In practice, most companies have perhaps 10-20 clusters of product/account segments, each with its own internally similar characteristics and profitability – but each very different from the others. These will be very obvious in your profit map, even with 70% accurate information.

The action question for *each product/account segment* is: what one or two things can you do that will have the biggest impact on profitability: Is it pricing? Order pattern? Product portfolio? Visibility into big orders, etc? I call these profit levers, and the big payoff comes from finding the smallest number of actions that produce the biggest results.

The most effective way to manage this process is to start with a rough profit map, using readily available information and estimates. The outlines, composition, and profit profiles of the product/account segments will literally jump off the page. By examining a few typical accounts in each segment, you will quickly see the most effective profit levers. But remember that these almost always are different for each segment.

At this point, it is helpful to sharpen your pencil where the additional accuracy will make a real difference: measuring the exact problem that the profit lever will fix, and developing a precise program to remedy it. This requires a higher degree of accuracy in order to specify highly focused initiatives in your target areas.

This process will enable you to match your degree of accuracy with the likely use of the information. Where better information is clearly not needed for a high-priority action, why spend valuable time and bandwidth on developing it? Instead, find out early where enhanced accuracy will really make a difference, and focus your time and resources where they will produce the biggest payoff.

Maximum profit impact

The more subtle problem with bad accuracy is that profitability management is a moving target. Companies change all the time, especially in a complex economic situation.

Even more importantly, when your managers have worked with an initial set of profit levers to produce radically improved profits, a new set of opportunities for profit generation will naturally arise.

This means that your profit map, along with your segment and profit lever identification, must be very dynamic. If you make extremely accurate measurement the implicit objective, it is very hard to move as quickly as necessary in order to maximize your profitability.

Another critical problem arises. When you focus on measuring everything extremely accurately (implicitly believing that everything is important enough to warrant it), you are in danger of flooding your managers and sales reps with so much information that they will not be able to act effectively. They will lose the critical understanding of the smallest number of realistic actions that will produce the most powerful set of results.

Instead, by aligning your information accuracy with the nature of the information use, you will have the biggest impact on your company’s profitability. And for all CFOs and other top finance managers, maximum profit impact is the ultimate management objective.