



Modern FP&A: Managing Profitability in Uncertain Times

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1 Introduction

Profitability is a vital factor when managing an organization. For some, it is the main target by which success is measured and investors are rewarded. For others, such as non-profitable organizations, profitability is more focused on ensuring costs are the same or lower than income and effectively applying resources to achieving the organization's aims.

“If your goal is anything but profitability... you'll hit problems.”

Michael Porter
economist, researcher and author

Closely linked to the subject of profitability is cash flow since **each are vital to the survival and sustainability** of an organization. Organizations can be the most profitable in their sector, but if they can't pay their suppliers on time, or are unable to meet other financial commitments, then failure is imminent, and profitability destroyed. As a consequence, when it comes to managing profitability, cash flow must also be considered.

While profitability is an easy concept to grasp, it is **notoriously difficult to manage**. Organizations that were once considered stable with guaranteed profits, can quickly find the reverse to be true when market conditions dramatically change. High street retailers are a good example. During the global pandemic their income vanished, although most of their costs remained the same. Similarly, organizations can experience a change in demand from high to low-margin products that adversely affects their overall profitability even though revenues may increase.

In times of uncertainty, the failings of systems and measures are brought sharply into focus. Managing profitability often requires a complete re-think on how an organization plans and the supporting systems that can help sustain profits in both the short and long-term. That's the subject of this paper.

2 Profit vs profitability

Profit and profitability are not necessarily the same thing.

Profit is often published as a single figure in annual reports which can disguise the hidden treasure of what future profits may be, or the death toll of losses to come. In most organizations, this figure is a consolidation of various sources of income and expenditure that can include both good and bad performance. The major concern though is that reported profit is not as tangible as cash. It is a snapshot view that demonstrates simply what has happened in the past and provides no forward-looking perspectives on long-term profitability. For example:

- Profit is **typically reported for a set period** e.g. for 3 or 12 months. While income may exceed expenditure in any particular time span it could be because costs have been deferred or were hidden at the time.

- Profit can be calculated in different ways and for different purposes. For example, profit for tax purposes is not the same as calculating profit for investment. Even product profitability can have two separate definitions, before or after shared costs are considered. There was an uproar in the German social media after Daimler showed a profit increase in 2020 despite 11% drop in sales. The company was accused of using government help to become richer, when in reality, most of the movement was driven by a provision release that had been made in 2019 for Dieselgate.
- Sales staff (or accounting staff) can be pressured to bring in a deal that may seem to provide profit this year, but whose real costs have been underestimated. By the time the costs are fully realized, they may be greater than any income and hence create a loss. The sub-prime mortgage scandal is a good example of this where banks showed a profit on transactions initially, only later to find out that these were actual losses as borrowers had defaulted.

In each case, profits reported are not necessarily a reliable indicator of profitability in the long-term.

A long-term horizon view is required for managing profitability, one that spans multiple accounting periods and takes into account product and service life cycles. However, this is not easy as the long-term view of profitability consists of two parts:

- Realized profit - which has now passed.
- Unrealized (future) profit – which is subject to estimation/ forecast.

True profitability takes both of these parts into consideration, yet ironically profit reported under accounting rules does not disclose those details. In this time of unknown unknowns, it is important to understand true profitability.

For our purposes, profitability is the amount of return made during the life cycle of a product or a service. Also, for simplicity, when we refer to product profitability we mean any type of offering sold to consumers, including services.

3 Six dimensions of profit management

Managing profitability requires an understanding of the different factors involved.

To manage profitability, organizations need to look at the underlying detail of its transactions and the market in which it operates. This allows the organization to gain an understanding of the profit level possible. While an organization analyzes the transactions, there are 6 interdependent dimensions (Fig. 1) that must be taken into account.

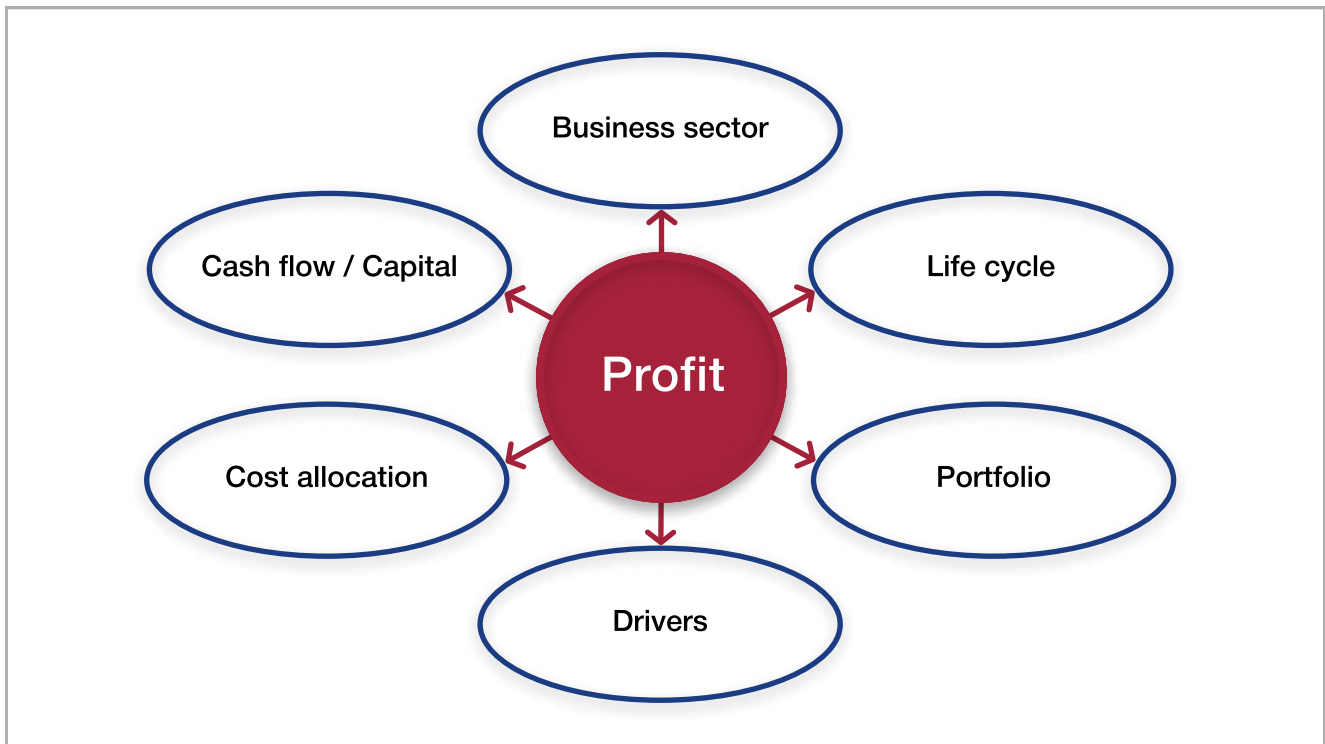


Fig 1: The six interdependent dimensions of profitability

- The **business sector** in which the company operates.
- The **life cycle** of its individual products.
- The **portfolio** of products that are being sold by the company.
- The **drivers** of costs and income of those individual products.
- The methodology used to **allocate** associated costs.
- The **amount** of cash and capital available.

Each of these **dimensions are connected** and should be managed in relation to each other.

Business sector profitability

When assessing profitability, there are several ways in which income less costs can be viewed.

These include:

- **By product.** This involves calculating the return made on each individual product. For some industries product profitability is calculated at a SKU level, while for others a product category level is sufficient for their needs.
- **By geography/territory.** This looks at the return made within individual locations, irrespective of the products sold.
- **By customer/group.** This calculates the profit attributable to a particular customer or group of customers, again irrespective of what they bought or where they bought it.
- **By sales channel.** This examines how the products were sold e.g. directly, on-line or via a distributor.

Profitability can also be assessed by combinations of the above, for example, particular products within a set market. As well as these traditional dimensions, artificial intelligence (AI) and machine learning (ML) techniques now allow us to create new clusters of customers and revenues that can be based on many different variables. Each cluster can have a different management approach to achieving profitability. In each case, gross profit can be calculated, with some allowances being made for the allocation of variable and shared organizational costs.

Understanding where costs reside in the business, can help identify unnecessary or high costs, for which cost reduction strategies can be developed that do not impact service levels. They also help in establishing which areas have the most opportunity. Comparing independent market research on competitor performance can show whether or not that opportunity is being maximized.

This analysis is linked to the organization’s strategic ambitions. For example, the market it wants to dominate, penetration achieved in any new strategic area, or the view of the best areas potential for future investments.

Life cycle profitability

Every product has a natural life cycle, whose stages often take the form of a curve as shown in Figure 2.

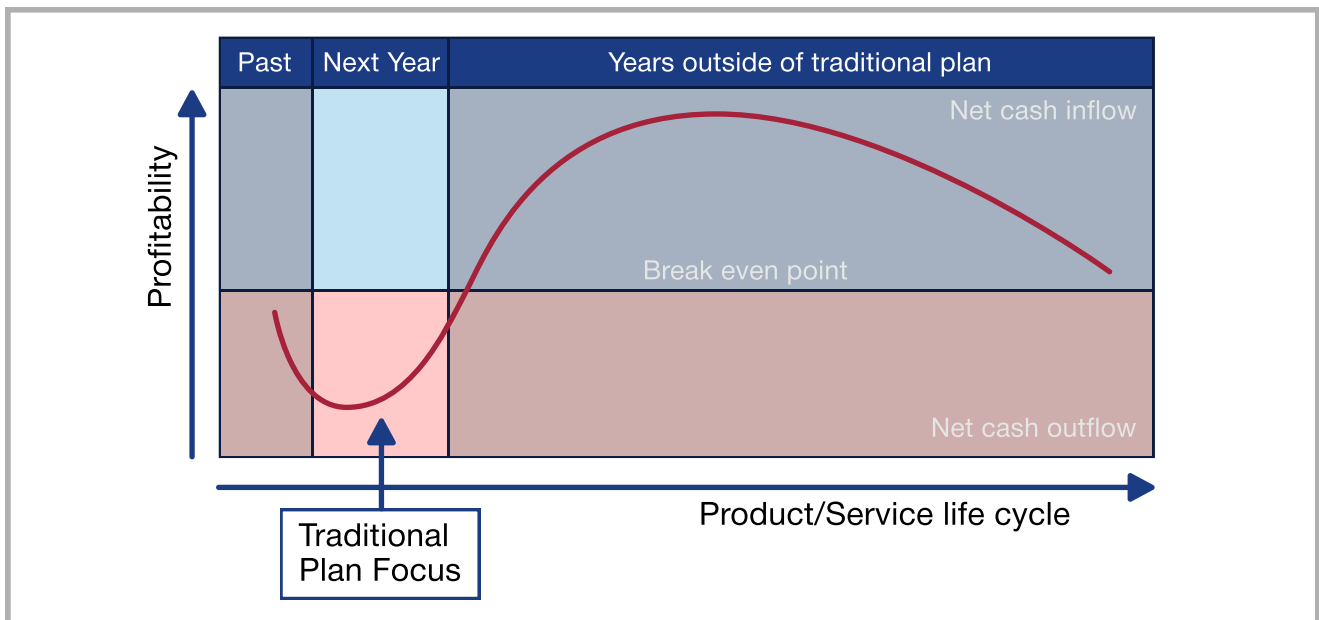


Fig 2: Individual product life cycle

This line tracks contribution and acknowledges that on initial introduction of a product there are start-up costs and a negative cash flow that will not be recovered until much later. In fact, most new offerings will make a loss at the beginning, but as time progresses and sales increase, those losses will reduce and hopefully turn into profits.

Understanding life-cycle costs has an additional benefit in that it allows organizations to gain a competitive advantage through pricing. For example, products can often become cash cows towards the end of their life as development costs will have ceased and production is now at its most efficient. However, **this situation will only be for a limited time.**

Traditional planning often fails in terms of managing profitability as the planning process tends to focus decision-making on a narrow time span that may or may not show the true profit potential of a scenario. Decisions on whether to launch a product or withdraw it must **always consider the cumulative possible returns** over the lifecycle of the product. Considering only a short-term narrow view, that does not respect the product's full lifecycle, may cause organizations to make decisions that reduce long-term profitability.

Another issue may arise if an organization's offerings are tied to the success of other products. For example, a company that offers solely maintenance services are typically dependent on the success of another product. This product may or may not be their own. In this case, their own **profitability is dependent on the life cycle of that connected product**. This life cycle must still be taken into account when managing future profitability.

Portfolio profitability

Most organizations offer a combination of products. As mentioned previously, each will have an individual life cycle that dictates the amount of profit and cash flow available to the organization at any particular time.

This is also true for organizations where **customer life-time value** is important. For some industries, such as insurance companies whose focus is on B2B, the life of a profitable customer is paramount. In this case a portfolio of products are supplied to a portfolio of customers. However, some of those products may not be profitable in themselves but they secure the customer who will then go on to buy other products that are profitable. The result is that overall profitability is retained over the long-term.

By carefully plotting where each product (or customer) is on its life cycle, management can assess the level of **short-term profits** (and cash flow) that can be expected at any particular point in the future.

This will be a consolidation of the current active products within the timespan measured (Fig 3). For **long-term profitability**, the complete set of life cycles needs to be consolidated.

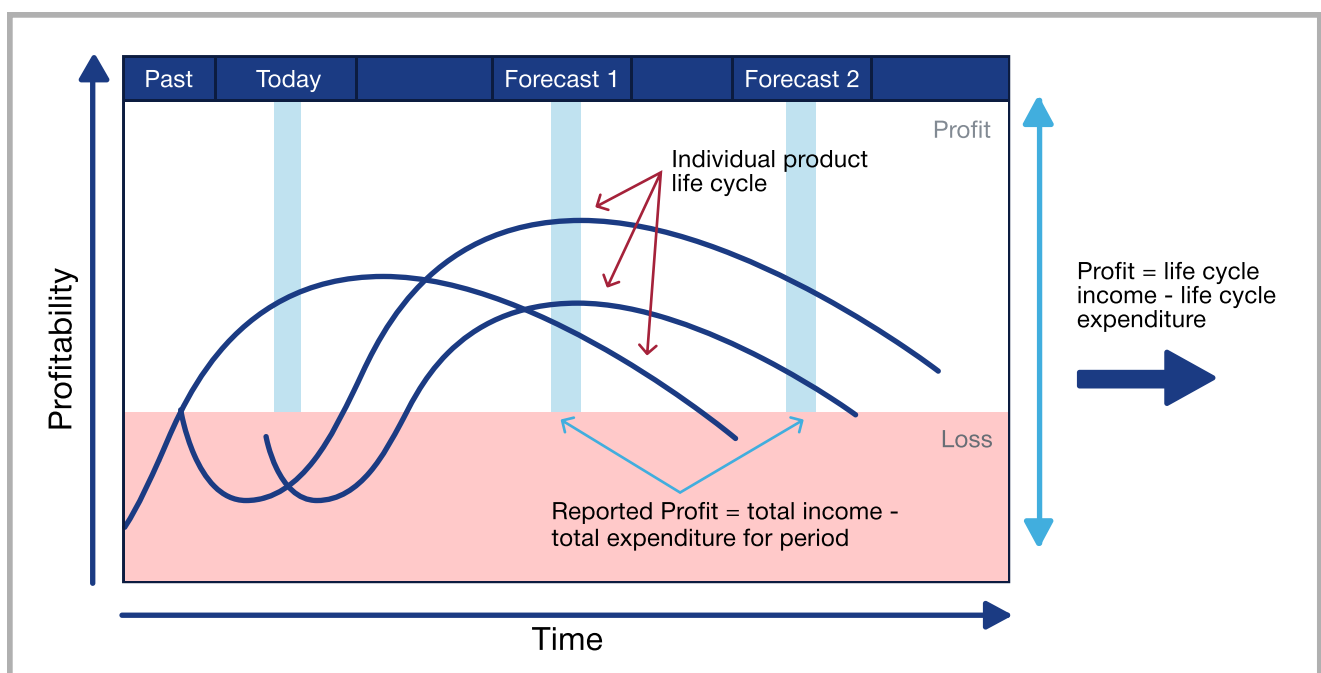


Fig 3: Product portfolio profitability

In some cases, organizations may have multiple portfolios, each of which serve a different market segment. Typically, each portfolio will have both products that perform at high margin and those that are potentially loss making. This is often plotted as a whale curve. This information helps an organization optimize the product mix and maximize the profitability of the portfolio as a whole.

For profit stability, organizations should ideally have a **balanced portfolio of products and customers**. The higher costs of one product or customer need to be offset by the lower costs, or cash cow status of the others. This approach also serves as a warning. When products near the end of their life, or are suddenly out of fashion, the organization will need to replace them so that overall profits do not suffer.

Drivers of profitability

This dimension looks at the drivers of revenue and costs that lay behind each product. **Drivers are those elements that directly affect the profit value** to the organization. For example, sales may be affected by a combination of price, internal marketing, promotions, service level agreements as well as favorable comments on social media. Similarly, material costs can be influenced by order size, stock availability and supplier location.

These driver relationships can be used to build a model that allows management to run simulations to **assess future profit sensitivity**. In the model, when the value of a driver is changed, it will show a corresponding predicted impact on costs, revenue and of course profitability. Some drivers will be under the control of the organization, for example price, while others may be outside of organizational control, for example the availability of raw materials. The ability to run this analysis in virtual real-time is vital if management are to quickly assess the impact of unforeseen, uncontrollable events (such as a pandemic) and put alternative plans into operation.

Driver relationships can be **complex and can change overtime**, but they are still better for making predictions than simple extrapolations of past trends or worse still gut instinct predictions.

Drivers and their values are best set at a detailed level. For example, the driver relationship of one product may be different between territories and across customer groups.

Knowing what the organizational drivers are, and how they change over time, are key to successful profitability management.

Cost allocation

Most direct costs are easily attributable to a product. However, true profitability requires the allocation of a whole host of other indirect costs, such as information technology (IT), marketing, finance and human resources (HR). **The challenge though is in how to allocate these in a way that attributes costs accurately and that provides insights for steering the business**. Some organizations use management accounting techniques such as activity-based costing (ABC), while others will use a mixture of allocation techniques as sales volume or head-count. Calculating allocations can be a time-consuming and complex process that requires huge amounts of financial and operational data if it is to correctly attribute costs to individual products, customers and market segments. Fortunately, today's modern technology solutions have these capabilities that provide a user-friendly, simple way of performing these calculations at the appropriate, detailed level through consistent, identifiable drivers.

However, this view of profitability comes with a warning. Whilst at a portfolio perspective, full overhead allocation can give a view of product profitability, there are two existing issues.

- Product profitability can be distorted when there are changes in overheads that do not correlate with changes in product volumes.
- The effect of allocations can drive dysfunctional behaviors below the executive level of an organization. For example, product managers will have no control over HR or IT costs, and are less likely to take ownership of those numbers. Therefore, it is important that when allocations are made reports and analyses show only what the recipient can control.

Cash and capital availability

As mentioned earlier, it is vital to connect profitability with cash flow, particularly when creating forecasts. Short-term shocks like Covid-19 can cause even the most profitable companies to go into bankruptcy when cash runs out. No one would have guessed two years ago that liquidity would affect companies such as Hertz, Intelsat, Debenhams, and a whole range of others, but it did.

Similarly, companies can find that they have insufficient capital to sustain profit growth. For example, to grow sales may require a geographic expansion which will require investment in offices and new staff, amongst others. Yet if the capital is not there, then that growth is not possible. This is particularly true of companies where cash is not realized until the end of a product life cycle. For example, those handling insurance claims may not receive cash until several years after the work has begun.

To avoid these situations, **profitability should always be monitored within the context of a 3-way model** that takes into consideration a snap-shot of profit, cash, and the longer-term value of the business as represented in the balance sheet.

Other factors to consider

As well as the above dimensions affecting profitability, there may also be others that need to be taken into account. For example, some **accounting revenue recognition rules** can influence short-term profitability due to the determination of when a sale is actually a sale. Similarly, when organizations prepare for major changes in consumer attitudes or government regulation through marketing costs, they are **not necessarily attributable to any current product**. They may well impact overall short-term profits but are necessary to safeguard the future of the brand.

4 Role of technology within FP&A

Technology is a key enabler that allows organizations to steer profitability.

Technology can revolutionize business models. For example, one elevator company used analytics to predict elevator issues which could be then prevented by better design and a more proactive maintenance regime. This led to increased profits for the company as they were then able to offer a subscription pricing model that benefitted all. The customer avoided downtime through far fewer failures, while the organization had a more competitive pricing model.

Within FP&A itself, technology can make a profound difference to its operations, and the support it provides to the rest of the organization. However, the areas of profitability discussed in this paper cannot be handled by spreadsheets and simple consolidation tools due to the complexity and data involved.

The technology required for FP&A is a subject in its own right which we will not detail fully. For now we want to highlight some of the critical technology components that are necessary for FP&A (Fig 4) that are impossible to perform in a spreadsheet.

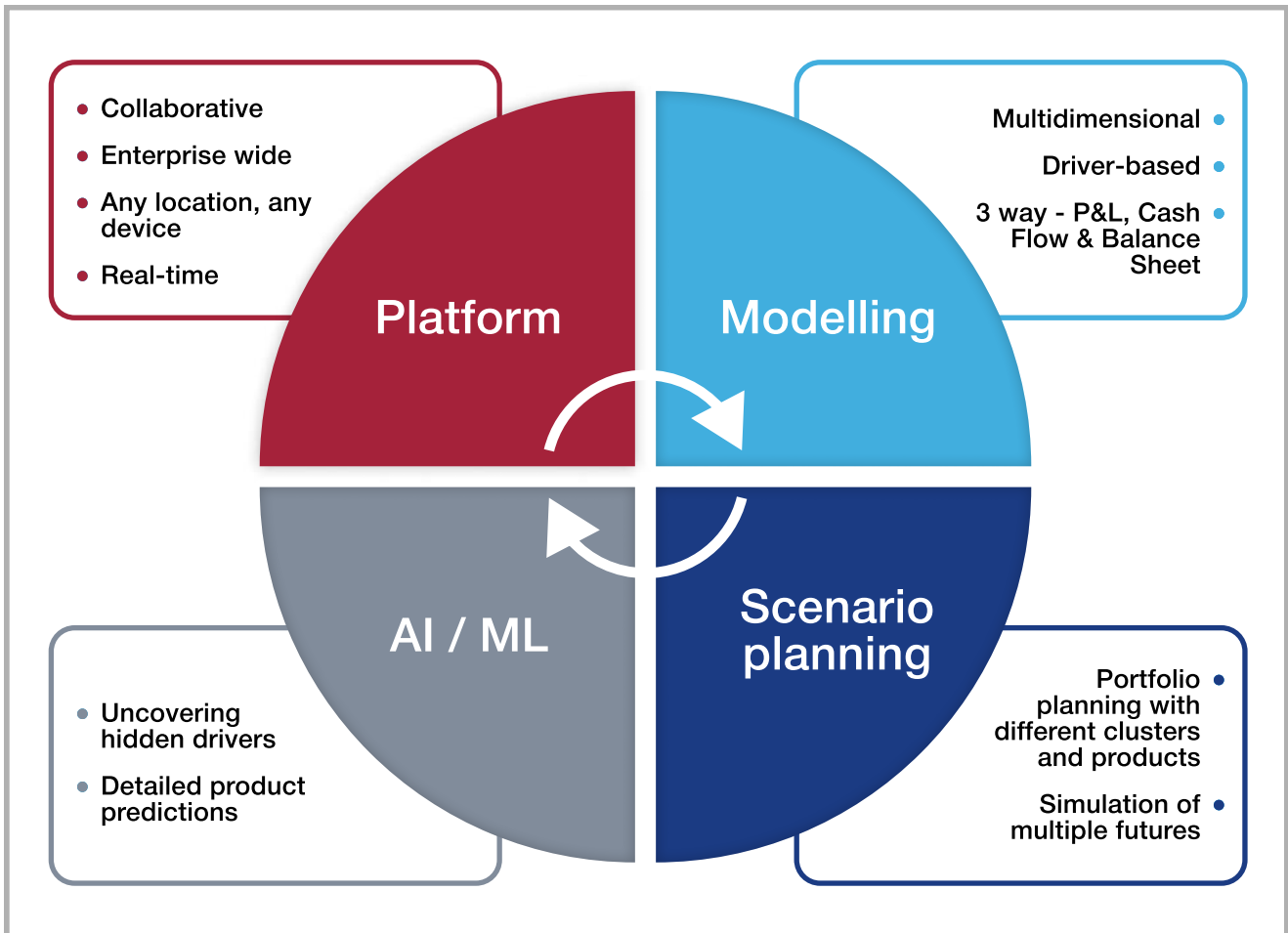


Fig 4: Key technology enablers for managing profitability

A single, integrated business steering platform

Managing profitability requires connecting users to a range of financial and operational data sources and ensuring they are able to collaborate with colleagues where they can determine which products and associated factors have the most impact. To do this, organizations need a complete business steering platform rather than a collection of individual linked applications. These systems should be fully integrated with the organization's financial/transactional systems, be able to support any number of locations and devices, as well as provide all of the modelling, allocations and analytic capabilities required by its users.

Multidimensional, real-time modelling

To analyze data by different business classes, products, territories, customer groups and so on, requires **sophisticated multidimensional modelling**. These models must allow the calculation of profit from multiple business perspectives, support cost allocation, and allow for the development and automation of drivers at a detailed level. Models should be able to produce an integrated profit and loss statement, balance sheet and cash flow statement so that any future funding requirements or investments can be anticipated.

AI/ML

The volume and complexity of data means advanced analytical techniques are required. Many of today's planning platforms include embedded AI/ML capabilities which are able to **identify business drivers and make predictions** of future values. By working at a detailed level, for example by product or customer, many organizations produce faster, better predictions compared to traditional methods, such as extrapolation or gut-based user estimates.

Scenario management

Today's uncertain business climate means that there is **not just one possible future, but multiple futures**. A change in one area can affect profitability overnight and so it is important to constantly run simulations and review their predicted outcomes. To manage this effectively, as covered previously, requires driver-based planning model(s) that are linked to the organization's strategic, business and operational plans (xP&A). On these models scenario management capabilities should be able to quickly and easily:

- **Manage a portfolio of products.** Each product's life cycle should be tracked so that managers can assess the product combinations that will give the best short and long-term profits.
- **Assess the impact of change.** For example, what happens if Product A's life cycle is shorter than expected, or if material costs increased by 10%.

Ideally this modelling should be **carried out in real-time** so that scenarios are always using the latest available results. From this analysis, managers can then adjust or develop new plans to either offset the impending changes or take advantage of them.

5 Next steps in managing profitability

Six action points that will improve the management of profitability.

To move to a more effective way of managing profitability, we suggest the following steps (Fig. 5). Most of these will require the power of a modern business steering platform as mentioned in the previous section.

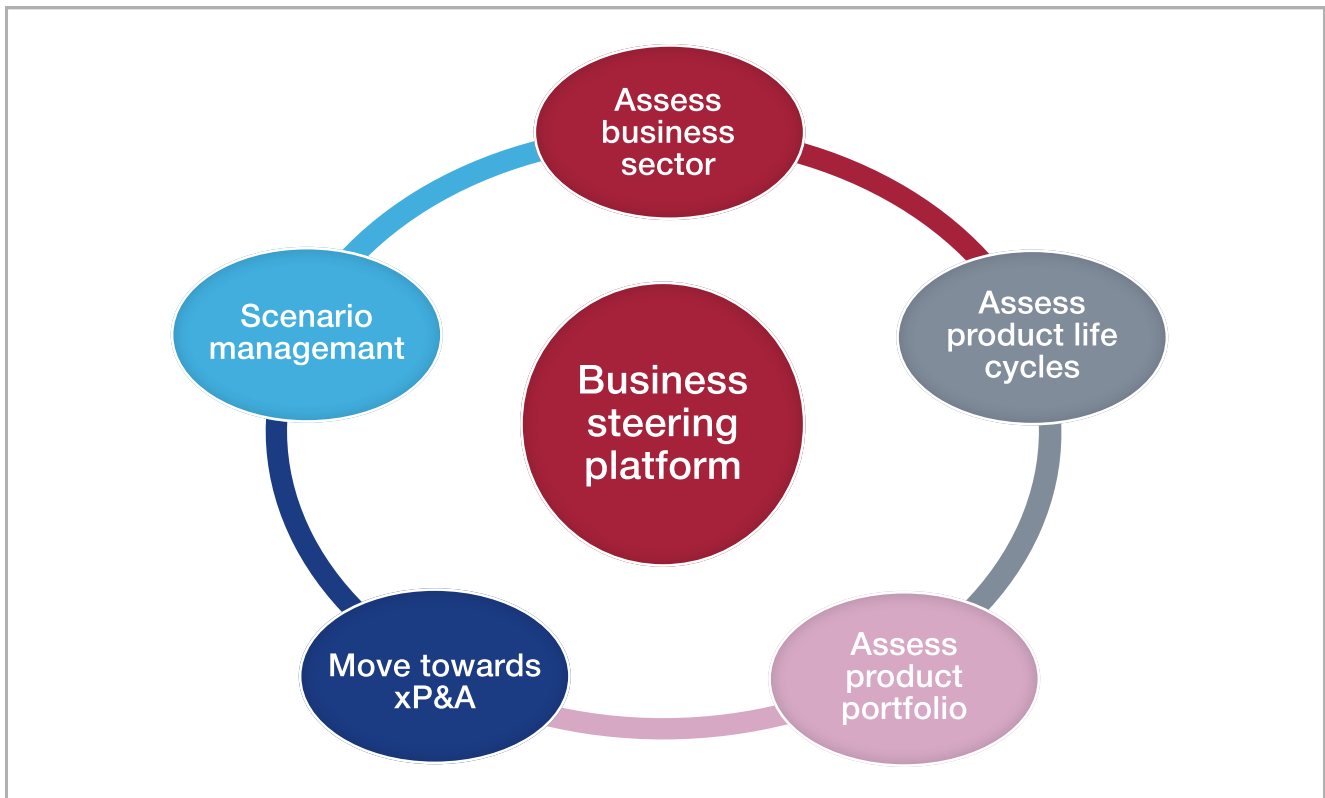


Fig 5: Next steps in managing profitability

Assess what business sector your organization operates in

To analyze the business sector you currently serve involves loading past sales data, assigning costs and then reviewing results from multiple business dimensions.

A number of years ago, the Finance Director of a well-known brewer wanted to know where their profits came from. As well as beer, they sold wines and spirits from other suppliers through various sales channels including their own public houses, those belonging to other companies, and independents. The company was profitable, but before making further investments the Finance Director wanted to check management assumptions were actually correct. Data from the previous 5 years was loaded into an analytic application that looked at the different permutations described in section 2. To their surprise, the most profitable area sat under the product heading of other.

Other was a catch all grouping for products outside of their main business lines. This was analyzed in more detail and showed that the majority of profits came from games machines in the pubs that they owned. The brewer thought they were in the drinks business when in actual fact they were in gaming industry. The lesson of this story is to never assume. **Use analytics to check that what you believe to be right is actually a fact.**

Once the sources of profitability are understood, the next step is to investigate where the greatest potential for profits exists and **how this aligns with company objectives and its strategic ambition.**

Assess product lifecycle status

Are your products at the start or near the end of their life? What is the **status of accumulated profits** and how will this look in the years to come?

Of course, the lives of some products can be extended through upgrades, but at some point, they will probably need to be replaced. This could be due to changes in market taste, or underlying technologies becoming outdated or no longer available.

For some industries, product life may only be a few days or weeks, but for profitability purposes it is important to track **the full life of any commitment** made to suppliers or customers.

In each case the profitability and cash flow results will change – they cannot go on increasing. It is important that a **realistic view of product lifespan is taken into account** when planning. Should the life cycle of a product be longer than anticipated, then that is a bonus.

Assess your current portfolio of products

This involves combining the different product offerings in a model that consolidates individual profit and cash flow. The model should allow the following questions to be answered:

- Will the portfolio deliver the expected profits in years to come?
- Does the portfolio reflect the strategic ambitions of the company?
- Are there any new developments in the pipeline that will offset products that are coming to the end of their lifecycle?
- What products are most vulnerable to foreseeable changes and how can we mitigate the potential impact?

Model the individual drivers of your products

Drivers of each product can be found by analyzing past performance **using advanced analytic capabilities** such as AI/ML. Drivers discovered in this way should be discussed among the management team to ensure that they are both realistic and accepted by all. This is not a one-time activity as drivers can change, particularly during a dramatic event such as Covid-19. Instead, it is **an ongoing process** that constantly refines the driver-based models and their predictions.

Move towards xP&A

Managing profitability is not the responsibility of one department but rather it involves different organizational stakeholders. This requires the complete **alignment of strategic, business and operational plans**, something that Gartner coined as xP&A, extended planning and analysis. One way of achieving this is for FP&A to spend time with the different functions in the organization to understand the support they need for their departmental decisions. This may require specific models for their particular situation but these results can be totally integrated to the overall business and strategic plan. By having one single plan that covers all areas, FP&A is able to create a planning and analysis process where profitability and cash flow is the main focus. Yet also where there is an ability to **constantly challenge** any plan or action that has been put in place.

Embrace scenario management

Scenario management is important since we must recognize that all organizations face **multiple possible futures for which they must be prepared**. Having a single target and a single forecast will cause organizations to view their performance as being either good or bad, when in reality it is only the business assumptions, targets and forecasts that have changed.

In this climate of uncertainty over the future, scenario management allows organizations to assess a range of possible futures for which suitable responses can be prepared. In this way they are ready to take action as events unfold with a considered response, rather than making a knee jerk reaction which carries adverse long-term impacts to profitability.

6 Summary

Sustainable profitability management.

Sustainable profitability is a hot topic in today's uncertain business climate where many organizations are faced with shrinking margins. Investors and management alike, seek profits that are sustainable over the long run and that are predictable.

Profitability management is key. It is a **focused activity** that recognizes the importance of the contributions of each individual product and service. Maximizing profitability is not just a question of reducing costs or improving sales. It **requires a detailed understanding** of the cost and income drivers, the life cycle of individual products, the portfolio of products offered, and the business sector being served.

Organizations do not become unprofitable overnight unless something catastrophic happens. Quite often the short-term profits reported are in fact not real profits as the anticipated accumulated returns were never real to begin with or were woefully inaccurate.

Fortunately, today's technological solutions provide a range of sophisticated tools that allow organizations **to manage the detail behind profitability** as explained in this white paper. This approach should provide the transparency required to maximize both short-term and long-term profits. And once those sophisticated modeling and allocation tools are in place, the technology foundation is set for considering other business issues that might need such a detailed level of analysis, such as sustainability initiatives, tax provisioning and transfer pricing...topics for another paper.

One final comment we would like to make is the people impact. Within the paper we have provided a framework on how profitability can be managed, but of course it requires people to carry this out. Organizations are in a state of entropy – making a change somewhere is bound to have a corresponding action to counteract it. To overcome this entropy, actions to improve profitability need to be underpinned by change leadership. This means creating or promoting a changed vision, developing a plan for change, and managing any resistance or conflicts throughout the change.

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Michael Coveney

Michael Coveney has over 40 years of experience in designing and implementing software solutions that combine ‘best management practices’ with technology to improve the efficiency and effectiveness of planning, budgeting, forecasting and reporting processes.

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If you have any questions or comments, please feel free to contact us via email info@fpa-trends.com.

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