Tracking Product Profitability - a key to success

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For firms operating in a fast-changing business environment with global competition, being on top of their game is more important than ever and success is crucial in order to beat the competitors. Although knowing that you are succeeding is good, knowing what brought the success is even better. The key to success lies in measuring performance and profitability, and understanding the reason to the results. The product offering is an important value creator in the bottom line and very much contributes to the firm success. In order to manage product performance, a company must measure product performance.

To manage a company’s product portfolio and to make strategic and tactical business decisions related to the products, information about product performance and profitability is a key input. Some companies face the problem of having inadequate knowledge about and insight into the portfolio regarding the profitability of each product. The product profitability is estimated from data with somewhat insufficient quality and reliability, with the help of tacit knowledge and experience from the organisation. As a consequence, the managers that are responsible for the products are forced to make decisions without complete supporting profitability data.

Why is it difficult to track product profitability?

Tracking of product profitability can be difficult for several reasons. Some factors complicating tracking of product profitability are that:

- complex product offering creates big data,
- complex organisational structure complicates information sharing,
- management accounting lacks guidelines and support,
- individual business units tend to focus on self-interested goals rather than on company goals, and
- implemented IT-systems are not aligned with business needs.

When a company offers high-technology products with a high degree
of customization, tracking product profitability becomes more difficult. Higher complexity of the products brings larger amount of product-related cost and revenue data. Keeping track of many details is difficult and in order to enable systematic and efficient product profitability calculations it is therefore often needed to define standard-products to simplify the calculations. There will always be a trade-off between having a systematic process and keeping track of all details in the product performance data.

Further on, organisational structures may hinder diffusion of information. Big, global companies have units located all over the world, which all interact with each other. The production and sales units are selling and buying products from each other during different stages of the product value chain, creating a very complex product flow. Costs and revenues related to the product occur during different stages in the value chain and thereby occur at different company units all over the world. Coordinating the collection of product performance data from all these units is a complicated task and puts high demands on IT systems that have to coordinate all information in a way that provides the data receiver with sufficiently sophisticated information.

Financial accounting is regulated by law and is therefore a prioritized activity at all companies. There exist many supporting guidelines and best practises about execution of financial accounting, in contrast to management accounting, which is an internal and optional activity not regulated by law. However, management accounting is not less important than financial accounting to reach firm success. The two accounting processes use different profitability measures with their own distinct purposes. Since the measurements and needed data are different, these processes must be organised differently. While consolidated profit is satisfactory in many financial accounting purposes, some measurements made for management accounting purposes may require profit calculations for specific products separately. Guidelines and implemented routines in management accounting are important to facilitate calculations of product profitability. It must be clear how to record needed data with a sufficiently detailed level and why it is done.
Depending on where the costs and revenues occur, product performance data is possessed by different business units as product companies or customer companies, in which the employees have different backgrounds and responsibilities. Since employees at a customer company often have a sales background and are held responsible for the revenue side of the equation, they tend to focus primarily on sales. Employees at a production company likewise focus primarily on production and costs. This natural difference in responsibility and focus contributes to difficulties in information sharing between the units, and hence makes the process of tracking of product profitability hard to perform. Having self-interested goals instead of corporate goals is risking the employees to lack understanding of the importance of sharing accurate information across units. Instead, inaccurate data might be transferred, which affects the reliability of the product profitability measures.

Tracking product profitability is a complex business process that is dependent on support from IT systems for collecting, storing and sharing product performance data. Large companies with many different units often have several IT systems implemented with complex linkages. Already implemented IT systems do however not always support tracking of product profitability because they are not optimally designed to align with the business needs. Making changes in IT systems is very expensive, and IT transformation projects are very time demanding. This fact makes it very difficult for firms to improve the impact that IT systems have in order to track product profitability.

What are the risks of not tracking product profitability?

Not tracking product profitability involves a lot of risks for a company. Without product profitability measures:

- product portfolio optimization is not possible,
- the quality of tactical business decisions decreases, and
- motivation can be negatively affected.

If a company do not track the profitability of its products, strategic decisions are made without a solid information base. This is a serious threat to the quality of the decisions. Not knowing which products that contributes to the profitability of the
portfolio, and which product that do not, implies a huge risk of removing wrong products or continuing to venture products that have already lost their competitiveness. Without knowledge about the product profitability, it is not possible to optimize the product portfolio.

Another effect is that managers cannot use helpful strategic management tools like Pareto analysis, the BCG matrix or product life cycle analysis. In the long run, not being able to optimize the performance of the product portfolio could have a severe negative impact on the overall company profitability.

Without following the trend in product profitability, managers are not able to evaluate whether a product’s performance is good or bad. This takes away the opportunity to make alarming efforts if a specific product suddenly starts performing badly. Furthermore, managers cannot see or measure the impact of implemented actions (e.g. sales efforts or cost reduction programs) that aim to improve product profitability, and therefore these actions cannot be evaluated.

Feedback on performance is a quantitative feedback element that is fundamental to shape a motivating working culture with incentives for continuous improvement. Quantitative feedback can be complemented with extensive use of qualitative feedback like encouragements, but it is not sure that is can act as a substitute. It is hence possible that the employees’ motivation would be higher with qualitative encouragements and feedback, which simultaneously was complemented with direct and tangible feedback, as the visibility of product profitability trends.

**Best practises for tracking product profitability**

Five principles are identified to achieve a well-implemented system for tracking product profitability. The system must be:

- systematic and efficient,
- providing information with an adequate level of detail,
- including the entire value-chain,
- easy-to-use, and
- reliable.

With a business process and system being systematic means a step-by-step procedure, and a high frequency in collecting the data and making calculations. Efficient is referring to the process with a high ratio of input to
output, and that the data is collected in the easiest way possible.

Some working roles, like divisional accountants, might be satisfied with a low level of detail, where only the consolidated profit is measured. Other working roles might need a more sophisticated level of detail and profitability measures related to specific products. The system for tracking product profitability must provide information with adequate level of detail that satisfies the need of all working roles that have responsibilities connected to the products.

It is important that the measures include the entire value chain in order to provide data that can be used as a base for making good business decisions. This means that the calculations include all revenues and costs connected to the specific product from the entire cycle from production to final customer delivery. The product profitability measure must tell the whole story and not only the product performance during parts of this cycle.

The sophistication and technical maturity of a profitability tracking system is irrelevant if the system is not used in the business. To get a high utilization rate, it has been shown that the system must be easy-to-use and that all employees involved in the business process have knowledge and implemented routines for how to use it and how to exploit the benefits of the system.

Finally, the best practice deals with the reliability of the system and the data quality. The product profitability is a key input to both strategic and tactical decision-making related to the products. It is therefore of greatest importance for the managers to access accurate data in the system to be able to rely on it.

If companies follow these five principles for how the IT system and business processes for tracking product profitability should be implemented, it will create a great support for high quality business decisions and good performance management.

Understanding what brought you forward will bring you further.