A new look at profitability

Profitability studies are now moving into the realm of distribution channels after having conquered products and customers

By Karine Benzacar, CMA

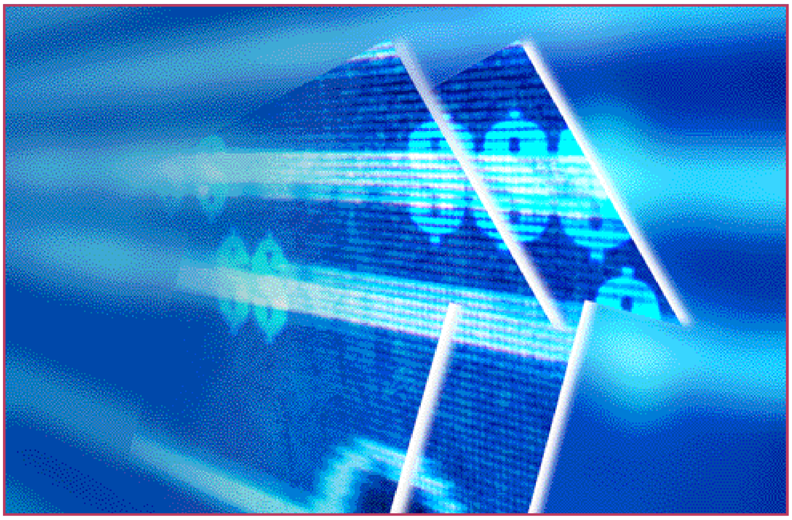
A few decades ago, activity-based costing (ABC) revolutionized the way companies looked at profitability. Prior to ABC, companies allocated overhead costs to products based on traditional cost drivers such as direct labour hours. This approach wasn't necessarily reflective of the amount of overhead consumed by the products.

The arrival of ABC encouraged companies to look at the activities that products actually consumed and to consider the cost of these activities in the overall product cost.

In company after company, the same trend manifested itself: products that were considered profitable prior to ABC sometimes became money losers when costs were considered at a more detailed level with ABC.

It wasn't long before the excitement about ABC spread from product profitability to client profitability. After all, if ABC was a more accurate method of calculating product costs and helping organizations identify the sources of their profitability, the same could be true for clients. If companies didn't look at customer profitability at a granular level and price their customers accordingly, they ran the risk of spending too much time and effort on serving their least profitable customers.

The latest generation of profitability studies is shifting from product and client profitability toward channel profitability. Companies are starting to analyze the impact of their distribution channels as the number of distribution methods expands. The logic behind this trend is clear: different channels will have different profitability levels. Just as it's important to recognize the most profitable products and the least profitable products, it's important to understand each distribution channel's profitability.



7 essentials for launching an effective channel profitability study

1. Senior management commitment.
2. Clear communication to employees of the business objectives of the study. Employees shouldn't feel their jobs are being threatened.
3. Employee buy-in and involvement in the study. They may have to change their work habits — tracking activities by channel, for example — so this can be a challenge.
4. Adequate funding, both human and financial, to conduct the study.
5. Project leadership by someone with a clear understanding of the business's dynamics.
6. A manageable number of distribution channels to analyze — ideally less than seven.
7. A manageable number of activities for which to track costs. The optimal number might vary from 50 to several hundred, depending on the size of the organization.

Information for strategic decisions

"Understanding the dynamics behind different channels is extremely valuable for us," says Charles Lambert, managing director of mortgages at Scotiabank. "We need to understand the sources of profitability and why the profitability of a mortgage might vary widely depending on whether it is sold through the branches, call centres, Internet, mortgage brokers, or our dedicated mortgage sales staff."

The importance of this profitability information has come to the forefront in recent years with more and more sales and service happening via the Internet. The Internet might appear more profitable since it eliminates some of the bricks-and-mortar associated with serving customers. However, it might have hidden costs or lost opportunities associated

with it. For example, if a customer walks into a bank looking for a mortgage, the banking officer might try to obtain the customer's credit card or RRSP business. It's much more difficult to cross sell over the Internet, which means that there is a possibility of lost business opportunities.

The concepts behind channel profitability are identical to those behind product profitability: measuring the revenues and costs associated with each channel to determine its profitability and taking strategic decisions to use the most profitable channels as much as possible while focusing less on the least profitable channels.

"In order to understand where we're really making money, we need to do a profitability analysis," says Maria Athanassiades, controller at MCAP, a national mortgage and equipment finance company based in Toronto. "When you look at things as a whole, it looks like the company's profitable but what's really happening is that a profitable customer or channel is subsidizing unprofitable ones. We need this information in order to make strategic decisions."

Implementing channel profitability studies

How do you implement channel profitability studies? In much the same way you assess the profitability of products or customers. Determine the activities associated with serving customers through different distribution channels. Calculate the costs of each activity by using information from the organization's general ledger and assign the activity costs to the channel that consumes the activity. Then compare this costing information to the matching revenue information for a given product (or a given customer) to calculate channel profitability.

This process is very similar to traditional product profitability studies. The general concept of isolating revenues and costs to channels is analogous to identifying profits by product. The benefits are enormous. Just think, if you knew that certain channels were more profitable to use, wouldn't this reshape your business? In the mortgage business, mortgage brokers are paid high sales commissions. Many financial institutions are now beginning to compare the profitability of this distribution channel with traditional branch networks to determine whether it is worthwhile to sell through brokers. In fact, at least one major Canadian bank doesn't even use mortgage brokers.

Are there challenges in implementing channel profitability studies? Absolutely. Just as ABC studies have numerous challenges associated with obtaining buy-in and support from key individuals within an organization, channel profitability studies have the same challenges. Unlike ABC studies, it's common to find that specific individuals may have spearheaded the business development through a particular channel and may be emotionally attached to that channel. They may not be receptive to finding out that the channel they are responsible for is less profitable than other channels.

One of the biggest challenges associated with implementing channel profitability studies is the availability of data. While companies have begun selling through different channels, they haven't necessarily tracked information connected to the various channels. Through product profitability and customer profitability studies, organizations have understood the importance of tracking information by product or customer. Now, they are beginning to learn the value of having sales and cost information by channel as well.

"We analyzed channel profitability and our study took much longer than originally anticipated," says Scotiabank's Lambert. "Our biggest challenge was sorting through the data at the bank because it was hard to find information being recorded by channel. We have now set up the proper procedures so that this data is readily available."

Channel profitability studies are here to stay. Global competition means that the companies with the best information will be the most successful. To be profitable, organizations must know where they derive their profits — from which products, from which customers, and now, from which distribution channels. ■

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