***Mystery of the disappearing profits***

**Challenge**

An acquired company with a $1 million bottom line in the previous year had declined to breakeven in the current year, despite 50% revenue growth that mostly came from expanding into a new business line. As the business became more complex, the traditional financial statements were not instructive. The business unit CEO and I knew that the answer to this conundrum related to the differing profitability in the various customer segments at their evolutionary stage – so this was a classic line-of-business profitability question.

***Our challenge: explain to the owners within 30 days why the expansion was a good idea and why the unit had become breakeven.***

**Actions**

The business unit CEO and I had recognized long before profitability questions arose that changes to the unit’s strategy had added complexity. In the near term, results were going to appear worse because our pricing was discounted to build a customer base that would ultimately create a recognized market presence. We also knew that the legacy businesses were not growing.

Whereas the company at acquisition date had two mature business lines, it now had four:

1. a startup segment,
2. a ramp-up segment,
3. a profitable-but-mature segment, and
4. a shrinking-but-mature segment.

Each was at a different stage of maturity and had differing economic prospects, opportunities and challenges. We needed to unbundle the summarized income statement into its component segments.

In anticipation of this, we began implementing a customer revenue database in 2012 and began capturing personnel costs and directly related costs, such as travel and entertainment, according to our segment-based organization chart. To push this project to completion within 30 days, we needed to accomplish the following:

* Use the customer database to determine annual revenues by customer segment. [Operations manager, financial analyst]
* Using a combination of organization charts and assigned customers, attribute staff compensation costs to segments [CFO, financial analyst]
* Determine algorithms for assigning non-compensation costs, in particular unit overhead [CFO, financial analyst]
* Isolate and quantify overhead costs being borne by unit that should be billed to sister companies [CEO, CFO]
* Present findings and strategic recommendations in a form that the owners would recognize as intellectually sound and defend the unit’s strategy to the private-equity analytical staff [CEO, CFO]

Having done many analyses in a multiple-product environment with staff touching more than one product, I was able to accelerate the process by providing intellectual guidance and decisions that prevented an over-engineered analysis. Seeking perfection in such a situation, if even possible, can cause decision paralysis – something we couldn’t afford. I also knew how to build the presentation in a way that would be resonant with the owners and their representatives.

**Results**

To the surprise of the owners, we delivered an illuminating presentation that addressed this fundamental profitability question within the 30 days allowed. Private equity analysts who expected to have to show us how to do this instead spent their time vetting our assumptions and algorithms.

We demonstrated to the owners that they were seeing “acquisition year” economics necessary to build a brand and business for the future. Each segment had different dynamics, requiring segment-unique prescriptions to improve profits:

* The large-customer startup segment intentionally had underpriced its product to build a customer base (and gain legitimacy) and was experiencing acquisition-year cost economics that would improve by 15-20 percentage points the next year. The time effort and producer pay associated with a new account is vastly greater than for a continuing customer. Pricing changes at renewal time and lower staff costs would resolve the current profitability problem.
* The ramp-up segment had new producers whose production lagged expectations. Therefore, their salaries were out of line relative to their customer-base revenues, so a combination of higher production and rationalized salaries was needed to achieve the minimum profit hurdle.
* The mature-and-profitable segment met company targets, but had poor growth prospects.
* The mature-and-shrinking segment should have been growing but needed new leadership, as the current leader was edging toward retirement and not engaged.
* Last, the unit had hired support staff that was being used throughout the company, but the unit wasn’t billing sister units for their fair share of the costs.

This situation led to clarifying discussions on the subjects of the cost of current investments to build a more valuable business for the future, and the owners’ acceptable time horizon. It also underscored the limitations of the financial reporting package that was being presented to the Board of Directors.