Understanding Profit/Loss Lineage to Successfully Deploy Information Management Technology

Every company wants to increase shareholder value and the prospects of all stakeholders, i.e. be profitable. Organizations increasingly are embracing information management and business information technology as a means of leading to profitability, but preparation - achieving an understanding of the company’s “P&L Lineage” - is an essential first step.

It may seem counterintuitive, but the fact is that within most organizations senior management does not always have adequate visibility into the various analytical processes that contribute to the profit and loss of their companies. True, some companies have a Business Intelligence Center of Excellence or a Business Analysts Center of Excellence, which do provide intelligence and analysis up the chain of command. But even these functions will be handicapped without being informed by what contributes to financial success or failure.

Typically, management charts out a plan to reach a variety of tactical goals, with the ultimate objective being to make a profit. Planning tools and applications can be used to forecast company performance and predict courses of action to achieve certain financial goals, based on past and present data. And tactics always can change due to external circumstances: During periods of economic growth, businesses will focus on increasing revenue; while during lean periods, management will strive to realize economies and reduce expenses and overhead. But these are very rough tactics that do little to hone and perfect the company's pathway to consistent profitability.

How can this process be optimally refined so that management is not involved in a guessing game—or worse, indulging in wishful thinking? What processes must stakeholders understand before a company employs technology to help it reach its profitability goals?

The Pitfalls of Poor Financial Visibility

Business intelligence and information management applications can help a company enormously in understanding and projecting business performance. But executives, and even many managers, rarely understand the underlying data issues that lead to success or failure. Without that understanding, technology not only can’t help, it can actually produce more harm than good.

When a business lacks visibility into its P&L Lineage, a common solution may be to build an IT solution using general-purpose applications, such as...
as an off-the-shelf electronic spreadsheet solution or a database management system. These represent a shortcut to the truth. In addition to shortchanging the financial analytical process, it handicaps the company in finding and deploying the most appropriate technologies available. It can lead to company frustration with IT itself, which has been burdened with unreasonable expectations. IT, in turn, becomes frustrated with the users of its customized solutions. IT blames business users, business blames IT, and the company’s strategic goal—to make a profit—is harmed.

Yes, the company may opt for a new business intelligence technology that seems more sophisticated—perhaps a prepackaged Information management application—but the conversion of reports from one tool to another does not change the information management process. And the company is faced with using a prepackaged solution that may not be aligned with its business or industry.

The core principle of information management for a profit-motivated organization remains the same: but only if the lineage to profit and loss is understood in advance.

Developing Information Management Processes

A best-in-class information management solution and methodology can help management arrive at logical conclusions about the factors that impact the profit and loss of an organization—that is, its P&L Lineage. Determining the factors that lead to profitability (or loss) requires an approach that accommodates and achieves three levels of visibility:

- Assuring corporate-level financial understanding
- Determining the revenue and expense drivers impacting on processes and departments
- Achieving visibility into the various other factors leading to profit or loss

Let’s examine each of these areas to see how, individually and collectively, they lead to an understanding of the lineage leading to profitability.

Corporate Level Financial Visibility

Assuring corporate-level financial visibility begins in the planning application phase and includes a projection of the expected profit and loss for the coming year. (Final actual P&L numbers from the preceding year are factored into the planning application.) Here, top-management analysis mainly focuses on what has been forecast, a possible budget, and how these might square with an actual P&L number. If there’s a gap between the forecast and what is actually achieved, management has to determine if the gap is acceptable within anticipated norms.

Naturally, any gap between projected and actual results will be scrutinized by investors and, in the case of public companies, by the stock market. The fact is, markets look at projected numbers in comparison with actual numbers and punish or reward organizations’ share price (stockholder equity) based on financial performance. It is essential, then, that top management has complete visibility into what has led to profit or loss—first, to more accurately predict performance in the coming year and second, to prepare for the response of investors to that performance. Significantly, the most granular visibility into the factors that influence revenue or expense drivers resides not with corporate heads but with department chiefs.

Processes and Department Drivers

A company’s P&L prospects lie primarily within the process chain and the company’s various departments. It shouldn’t be terribly difficult to determine “good” and “bad” results at this level since the process seeks balance and reconciliation between revenues and expenses. Profitability can only be achieved by developing a methodology to do just that.

It is essential to closely monitor the revenue and expense drivers, with the recognition that every industry has its own unique process chains and departments. In most companies, the sales team drives revenue while supporting departments (such as IT) drive expenses—although, clearly, sales has to accommodate itself to its needs.

Any good information management solution should be able to track the dollar right to the bottom.

Here, financial visibility must be built in at every stage.
Achieving P&L Lineage Visibility: A Scenario

Let’s consider an example of this process within the insurance industry. For an insurance company, profit and loss are determined by the revenue gained from policy premiums, minus both operating expenses and the money paid in claims. Any financial planning application that an insurance company employs will include these elements in forecasting performance and determining an annual budget.

At an insurance company’s department level, claims become hugely significant. The claim numbers are highly influenced by factors such as subrogation, salvage, litigation, negotiation, auto appraisal, fraud, coverage, medical treatment, claim handler efficiency, and lines of business. With our hypothetical insurance company, achieving clarity into its P&L Lineage can be represented by the diagram below:
Looking Forward

As organizations move forward in their search for appropriate business intelligence technology, we recommend they consider the following factors closely:

- Seek an understanding of what leads to profit and loss—first at the top, with executives stating broad strategic goals, then with the detailed expertise and dedication of department heads, searching for any and all barriers to profitability.
- Acknowledge that the IT department plays an essential role but only after the P&L Lineage is established. Once all factors are considered, including pathways to incremental revenue and efficiencies, and the multiple contributing factors to profit or loss are identified, the search for appropriate information management technology can then be undertaken.
- Consider that off-the-shelf or prepackaged solutions to information management are shortcuts at best. Their deployment offers a solution to no clearly established problem because that problem has not yet been stated in a P&L Lineage analysis. They can be prone to simplistic analysis or even provide misleading information when they are not specific to an industry or business.
- Head off interdepartmental feuds that result from inadequate up-front P&L Lineage analysis, which leads to finger-pointing and blame. This is not the pathway to realizing a successful company, either in its financials, its place in the investment markets, or in the efficiencies and satisfaction of its workforce.
- Determining a P&L Lineage depends on a company’s specific industry and its own place in that industry. Whether the organization is an insurance company, a bank, some other financial services organization, or involved in manufacturing or even professional services, the various departmental and other factors impacting on profitability will be different, and they must be accommodated in a clear P&L Lineage hierarchy.

About the Author

Kumaran Pillai is Senior Architect within Cognizant’s Enterprise Information Architecture practice. He has more than 20 years experience in strategic consulting, with expertise in data warehousing, business intelligence and the development of Business Centers of Excellence from the ground up. His work has benefitted finance, marketing and operations within such industries as financial services, insurance, manufacturing and government. Kumaran has extensive experience in such applications as Cognos, SQL Server, Oracle, DB/2, SAP and Sybase, and is both a Cognos and Microsoft certified Business Intelligence/Data Warehouse Professional. He holds an M.S. from Anna University, Tamil Nadu, India; an M.S. in Business Administration from the University of Central Oklahoma, Edmond, OK, U.S.A.; and a Master’s of Technology from IIT Technical Institute, Delhi, India. He can be reached at kumaran.pillai@cognizant.com.

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