

Executive Brief

Financial Analysis Clears
the “Profit Haze”

by Russell Cooper

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Corporate executives are constantly looking for ways to increase revenue, profitability, and shareholder value. Moving into new markets, building new products, making acquisitions, and creating new business models while optimizing internal financial and operational effectiveness are just some of the strategies employed to achieve these objectives.

There is one challenge, however, that tends to hinder growth and profitability no matter which strategy is employed: the lack of visibility that executives have into the financial state of the business. Informal “shadow IT systems” consisting mainly of spreadsheets and manual processing crop up in an attempt to provide insight into the business. Although spreadsheets work at an individual level, they do not effectively scale to support a collaborative environment of multiple diverse business units. The situation is compounded when the business becomes more complex as a result of internal and external changes, such as mergers and acquisitions, expansion into new markets and new economic, political and regulatory environments. In the worst case, a lack of insight into the impact of these changes can paralyze an organization.

Financial analytics solutions improve corporate performance by creating visibility into all areas of an organization, effectively clearing the haze that exists around the true state of the company. They are designed to greatly increase business agility by providing an accurate, up-to-date, and comprehensive picture of the business. By improving visibility into areas such as the most profitable customers, the best suppliers, and the most profitable products and services—and by providing a consistent definition of financial terms such as profit and costs, an organization can more quickly and confidently make strategic business decisions.

In addition to increasing business agility, financial analytics solutions enable organizations to reduce risk exposure and plan for change. They allow executives and managers to instantly model the effects of unforeseen and planned events and take preemptive action based on these insights.

This paper discusses the challenges that organizations face when trying to understand their existing business positions and future business scenarios. It focuses specifically on profitability analysis.





Introduction

If your CEO—or board or shareholders—asked you an apparently simple question: “Who are our 10 most profitable customers?”, how long would it take you to answer? Would you know what they meant by “profitable”? Would you know what they meant by “customers”? Whom would you ask, or where would you go to find the answer?

It’s frightening to think about the amount of money being wasted by organizations around the world due to their inability to get clarity on their financial performance or situation. Investments in business units are made inappropriately, based on (at best) an approximation or “educated guess” of their profitability, or (at worst) their “gut feel.” Without clear insight into the real financial state of the business, organizations are shooting in the dark when making strategic business decisions.

Improved performance management requires extracting the maximum value from your business as a whole by analyzing each component part. It requires identifying the areas of the business that are underachieving, understanding why, and taking the appropriate action in a timely fashion. It requires identifying the most profitable areas of the business to maximize the return on your investments, and increasing agility within the business by predicting and responding to changes in market conditions to gain a competitive edge.

Complexity Drives the Need for Improved Performance Management

Performance management comprises many areas, including marketing effectiveness, resource allocation, sales optimization, pipeline management, and financial analysis. As organizations grow, particularly by acquisition, their business environments become more fragmented and complex. Getting a handle on every aspect of performance management becomes more and more challenging, requiring huge amounts of data integration, aggregation, and manipulation.

The driver for formalizing the language, definitions, processes, and technology around performance management, therefore, is not the size of the organization, but its complexity.

This paper focuses on the challenges presented by financial analysis—arguably the aspect of performance management having the greatest impact on an organization’s revenue and profitability growth.

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The Profitability Challenge

So, have you found out who your 10 most profitable customers are yet? If you have, a) you've guessed, b) it's one of a handful of KPIs that you've made a significant investment in identifying, or c) you're in the minority of companies that can actually access this information quickly and easily—congratulations! Most organizations, however, face many challenges when trying to understand profitability.

No Single View of “Profit”

The majority of large organizations are so complex that there is no single, company-wide definition of financial metrics such as “revenue,” “cost,” “profit,” and “gross margin.” Each line of business likely has its own method for measuring the profitability of customers, products, or market segments. This is particularly an issue in global organizations where accounting rules are different in every country.

Islands of Information

Revenue and cost data is often held in multiple disconnected IT systems, each with its own method of recording this information. Decentralized “shadow IT systems” sprout up as the business grows, usually in the form of myriad spreadsheets and error-prone human intervention. The purpose of these spreadsheet systems is to connect the disparate IT systems and create that elusive (and often notorious) “single view of the truth”—sometimes across the organization, but more often within a single business area. However, these spreadsheet systems frequently manipulate source data to the point where the data is stale, unrecognizable, and virtually meaningless.

Islands of Responsibility

Responsibility for performance management is also isolated in disconnected organizational islands. Decision-makers within business units or departments are given the responsibility to improve efficiencies within their business areas without being accountable for the impacts on areas of the company outside of their units. This further encourages the creation of information islands and shadow IT systems.

Without a single clear view of the interdependencies between the various areas of the business, it is difficult for decision-makers to predict how an action in their area of the business will impact other areas of the business. Decision-makers therefore cannot be held accountable for any negative consequences of their actions until they have visibility into those consequences.

Error-prone Processes

With each step in the spreadsheet process, there is a danger of introducing errors into the data. And there are many, many steps in these spreadsheet processes. Some errors are introduced inadvertently. One need only search the Internet for “spreadsheet errors” to find dozens of horror stories resulting from simple mistakes made while working with spreadsheets. In one case, a single error in a spreadsheet resulted in shares in a public company dropping more than 25 percent, prompting the resignation of the CFO¹. Numerous spreadsheet audits have shown that 100 percent of complex spreadsheets contain at least one error with around 5 percent containing very serious errors². Other spreadsheet inconsistencies may be due to the tendency of line managers to “tweak” their financials in order to represent themselves in the best possible light.

Huge Effort Required to Maintain Manual Processes

Without a single-source system for cross-company profitability information and analysis, organizations face a major challenge in the time and effort spent updating spreadsheets, coordinating changes, and determining which numbers are correct and what they mean. Because each business unit measures its performance differently, comparing performance and conducting analysis across units to determine opportunities and challenges requires a large amount of human effort. This becomes even more of a challenge whenever change occurs within the business. Add to this the various checks and balances designed to ensure spreadsheet accuracy, and you end up with a significant resource requirement.

Aside from the cost of this huge manual effort, the lead time between a business event occurring and the relevant managers or executives becoming aware of the event is very extensive. Opportunities are not seized due to the fact that they are not recognized until they have passed. Additionally, issues that could easily be “nipped in the bud” grow until they require significant effort to resolve. Business agility is non-existent.

It is a sobering thought that critical business decisions continue to be made on the basis of data retrieved in such a manual, untimely, and error-prone fashion.



¹ “Eight of the Worst Spreadsheet Blunders” – CIO.com, August 2007

² “What We Know About Spreadsheet Errors” – Raymond R. Panko, University of Hawaii, May 2008

The Challenge for IT

IT organizations are under pressure to “do more with less.” In addition, they have policies, procedures, and processes designed to ensure consistency, stability, and reliability in the solutions that they deliver. Two core areas of financial analysis conflict with these fundamental objectives: flexibility and a requirement for a deep understanding of the business. Re-aligning project teams within IT to address these requirements means an investment that most IT organizations cannot justify.

Flexibility

There are two kinds of flexibility. The first is flexibility of the approach used to create the solution. The application development group within IT organizations usually has solid experience and processes in place for designing and developing transactional applications that support well defined business processes. Examples of these transactional applications include customer relationship management (CRM), supply chain management (SCM), and enterprise resource planning (ERP). The path to creating these applications is well trodden: gather business requirements, translate the business requirements into functional requirements, design and build the solution, test the solution, and deploy it. “Success” in these projects is defined by on-time, on-budget delivery of the originally specified solution. A change in requirements partway through the project, therefore, results in a lengthy change request process.

Financial analysis solution requirements, by their nature, change constantly. Requirements specified one day may be obsolete within a few months. The “traditional” IT project process is not designed for this type of never-ending, constantly changing project. Financial analysis solutions require a quick response to change. New business rules must be reflected within the system in a very short time frame. This implies a dedicated IT resource, ready to act on any change request from the business, and the adoption of a highly iterative approach.

The second kind of flexibility lies in the solution itself. IT is experienced in delivering transactional applications with embedded business logic and process “states” that support existing (usually stable) business processes. Rarely is IT experienced in delivering flexible solutions that can be quickly updated to adapt to new business logic, processes, models and “states.” Yet this is exactly what a good financial analysis solution requires. The priorities of stability, reliability, scalability, and auditability all take precedence over flexibility in solutions typically delivered by IT.

Understanding the Business

A good financial analysis solution should reflect existing business models and adapt quickly to new ones. In order to achieve this, IT would have to work very closely across all departments to understand the nuances of each. However, business unit managers and executives understand their processes better than anyone within IT can ever hope to.

Organizations use financial analysis solutions not just to manage and monitor existing processes and states, but also to define as-yet-unknown processes and states. The users of a financial analysis solution are often unsure themselves about what changes they need to implement within the business to maximize revenues and profits.

Taken together, there are very few IT organizations that could justify the investment required to build such a flexible solution, commit to such stringent service levels for updates, and spend the time understanding the business at the level required.



The Opportunity for IT

An alternative to building a solution from scratch is to adopt a dedicated financial analysis solution that enables business users to take control of the business logic within the application. Financial analysis solution vendors understand the challenges that managers and executives have in managing and analyzing financial information across the organization, and have developed solutions to address such challenges. These solutions allow IT project teams to open up options to business users rather than imposing limits on their requirements.

Commercial financial analysis solutions form the core of business strategy development and are therefore highly valuable within the organization. The opportunity for IT is to support business users in the implementation of these systems, enabling IT to move further up the value chain from “core infrastructure” to “business support service.” The result? An increase in the value of IT to the business, and an aligning of IT with business strategy—two objectives that many CIOs have at or near the top of their priority list.



The Ideal Solution

The ideal financial analysis solution clearly lies somewhere between the flexibility of the spreadsheet and the auditability, robustness, and real-time nature of a traditional transactional IT system. It must be a broad, end-to-end solution, capable of accessing multiple source systems, seamlessly integrating into your solution set with minimal disruption, and delivering real business value.

Flexible

The solution must be flexible enough to support the models and processes that exist within the existing spreadsheet systems. It should be a toolkit that enables the business users themselves to define the various “states” and processes, rather than an out-of-the-box application that IT must set up, maintain, and manage.

Easy to Use

Spreadsheet users must find the solution as easy to work with as their existing system; that is to say, based on a spreadsheet paradigm. This way, users waste no time in transitioning to the new system, which reduces time-to-value and ensures high adoption rates.

A Unified View

The ideal solution must enable the business to create a common definition of financial measures such as revenue and cost across the organization, so that you can compare apples to apples and oranges to oranges. It must also make users aware of the impact their decisions have on other business areas.

The solution must also enable managers and executives to take a view that goes beyond their own business units and monitor their performance relative to their peers, the industry, and previous periods. It must enable them to measure resource utilization and to use this information, along with profitability measurements, to justify requests for increased resources or investments.

Current and Forward-looking

The ideal solution must not only present the most up-to-date information from source systems, but must also instantly reflect any changes to business models made by users. In addition, the ideal solution must enable scenario testing to assess alternative strategies.

Business Ownership

Finally, the solution must be under the ownership of the business, which has responsibility for defining the business models.

At a technical level, it must be flexible enough to access data in every source system and must be available to every authorized user. It must allow free-form data entry, have support for queries, what-if analysis, and instant publishing of updated models.

It must be noted that technology alone is not the solution. Without some form of financial foundation and process in place, you cannot expect to implement a financial analysis solution and meet all of your challenges overnight. Technology eliminates the manual manipulation of data, resulting in greater efficiencies and business agility, reduced cost, and reduced errors. It also solves the issue of the “disconnects” in the company: disconnects between finance and the business, disconnects between various units within the business, and disconnects between various support systems. Business processes must already be in place in order to take advantage of technology.

One example of a financial analysis solution is IBM Cognos TM1. TM1 is an analytics tool kit that is designed for implementation in large organizations that have complex financial structures. Given that the notion of “profitability” is different in every organization, TM1 customers can tailor the financial analysis solution to meet their specific needs.

IBM Cognos TM1 uses the familiar row-and-column approach to enable users to model their business as they would with a stand-alone spreadsheet. Users can modify cells to perform what-if analysis on models and update them directly through the spreadsheet interface. Updates are reflected instantly due to TM1’s in-memory analytical engine.

A further benefit of having a centralized, in-memory analytical engine is that every business unit has visibility into all other areas of the organization. Users can see the ripple effect across the organization, positive or negative, of any change they make to the models.

TM1 also extends traditional spreadsheet functionality by offering multidimensional functionality—as opposed to a single spreadsheet which offers two dimensions: rows and columns. For example, a spreadsheet will readily enable viewing and analyzing product data across geographies, but when a time dimension is introduced, analysis becomes much more complex.



The Benefits of Centralized Financial Analysis

There are numerous benefits of building a single dependable source for profitability information. To start, you can eliminate embarrassment when asked for basic financial metrics—such as your top 10 most profitable customers—by the CEO, board members, shareholders, or regulatory bodies.

Perhaps more important is having a tool that provides the insight you need to increase revenue, profitability, and competitive advantage, while minimizing risk exposure and reducing the cost of running the finance organization.

Increased Revenues and Profits

When you can quickly and easily identify which are your most profitable customers and products, your best suppliers, and your most effective channels to market—and understand why they're top performers—you can apply the underlying enablers for these successes throughout the organization and focus investment in these areas.

For example, a financial analysis solution can allow you to measure the financial success of sales promotions based on any number of dimensions, giving you a deeper understanding of customer behavior, and providing the insight you need to profitably promote the right product to the right customer base in the right geography at the right time.

Improved Competitive Advantage

Increased Agility

A company that is agile enough to adapt quickly to the changing environment is a company with a competitive advantage. The ability to implement new business models, identify new market opportunities, and quickly pursue those opportunities enables you to compete in your market more effectively.

The IBM Global CEO Study 2006 found that among analyzed firms, “business model innovation had a much stronger correlation with operating margin growth than the other two types of innovation”—the other types being operations and products/services/markets³. Business model innovation is stifled without business agility.

Greater Preparedness

What-if analysis enables companies to evaluate how change—occurring within or outside the business—might affect them. Analysis can be performed on any number of scenarios, such as “What if we purchased this company?” or “What if we swapped suppliers?” Such scenarios help organizations move from being reactive to change to being proactive and managing for change.

Mitigated Risk

Companies that are clear on the financial state of the business and the ways external factors affect the business are more aware of—and therefore more responsive to—risk events. For example, the company that has clarity on where and how the price of oil impacts the business, and puts contingencies in place, will be in a more competitive position than its competitors.



³ IBM Corporation. “[Expanding the Innovation Horizon: The Global CEO Study](#).” 2006. [registration required]

Reduced Cost and Increased Value of Finance

Having a single source system for financial analysis enables you to reduce the amount of human resources required to gather and analyze financial information. The manual overhead of working with spreadsheets to extract, aggregate, compare, analyze, and share data is eliminated. In addition, time spent agonizing over which set of data is closer to reality is eliminated. This results in a reduction in the cost of the finance organization. In addition, analysts can perform analysis rather than simply reporting, increasing their value to the company.

Increased Confidence in Decisions

Because the information being analyzed can be relied upon as accurate, up-to-date, consistent, and dependable, your confidence when making business decisions—such as how to allocate resources within the business—increases. Knowing where to invest in order to realize a maximum return on investment results in higher revenue growth.

Conclusion

Critical strategic decisions should be based on clear visibility of the facts and on a view of likely future scenarios. Clearing the haze around revenue, cost, and profit across an entire organization is not a trivial task. Shadow IT systems that attempt to address this challenge are resource-intensive, cumbersome, and error-prone, hindering growth and profitability.

Can you afford to continue to make strategic business decisions based on inaccurate, outdated information?

Financial analysis solutions are designed to be agile and dependable, bringing clarity to the reasons behind your growth and serving as a compass to steer you toward future growth. They enhance the value of the investment you have made in your existing business support systems such as CRM, ERP, SCM, and sales force automation (SFA) over the past decade and distill enterprise-wide information into the answer to a few simple questions: How can we increase revenue, maximize profits, and increase our competitive advantage?

About the Author

Russell Cooper is TEC's business intelligence (BI) analyst. He has over 15 years of experience in the enterprise software industry, and has a keen interest in how organizations maximize the value of their existing data. During his career, Cooper has worked exclusively for companies that have built their businesses around the storage, movement, and retrieval of data—from electronic data interchange (EDI) to BI, from fourth-generation language (4GL) application development to geographic information systems (GISs). This experience has afforded Cooper a broad perspective on data and data management.

Now based in Ireland, Cooper has a global perspective on business, having worked in many countries including the UK, Australia, Denmark, and the US. His consulting business focuses on helping organizations to understand their technical strengths and differentiators, and to articulate these to prospective customers.

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