IT as a Profit Center: Financing the next big Project

By Cooper Smith in conjunction with Harris Kern's Enterprise Computing Institute

Most of us already know that today's corporate IT infrastructure needs to become more aligned with the organization's business strategies. By aligning the goals of IT with these strategies IT managers cannot only contribute to these strategies, they can begin to make headway in the never-ending battle of turning IT from a "cost" center to a "profit" center. Not only does this make for a more secure environment for IT professionals to work, but it also makes a much more certain and, hopefully, profitable business environment for the organization to thrive even in the midst of economic downturn. In short, a little knowledge of how corporate finance works can go a long way to aligning the needs of both the business and the IT organization for their mutual benefit.

Almost all real businesses in America are required to keep at least three major financial statements available to measure the organization's financial performance, the *income statement*, the *cash flow statement*, and *the balance sheet*. When we speak of whether IT appears as profit center or cost center we are speaking of where the money spent by IT or made by IT appears on any or all of these financial statements. Once the IT manager understands how these statements relate to the business goals and strategies in the minds of their executive managers, peers, and partners, it is much easier to meet not only IT objectives but business objectives as well.

In short, these 3 major statements represent the following:

- **The income statement** shows the bottom line: it indicates *how much profit or loss* a company generates over a period of time—a month, a quarter, or a year.
- **The cash flow statement** tells *where the company's money comes from, and where it goes*—in other words, the flow of cash in, through, and out of the company.
- **The balance sheet** shows a company's financial position *at a specific point in time*. That is, it gives a snapshot of the company's financial situation—its assets, equity, and liabilities—on a given day.

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For the purpose of this article I will focus primarily on the **income statement**. Mind you, any manager or employee of a large corporation should be as familiar with all these statements as they are with the cafeteria menu but that is not always the case. They are usually printed with every company annual report. These days almost all such information for every corporation filing with the SEC can be found on the Internet. They are readily available and should be taken advantage of no matter what level you work at. Certainly senior executives like CIOs, Senior VPs, and directors should be as involved in what these reports say as knowing where to find them. If for no other reason, to know whether the financial health of their company is going to not only be accommodating to IT initiatives but also accommodating to maintaining the current IT personnel. This may seem like common sense, but the feeling that IT and "techies" exist in a world all their own is, unfortunately, still as prevalent as it was 20 years ago. I believe this is part of the reason why economic downturns have a tendency to hit IT departments first and particularly hard. It is very easy for senior managers to ask the question, "Why are we paying so much for IT? Just so I can get management reports on my PC?" Rarely does anybody respond with a clear, well thought out answer.

IT managers have to find ways of "adding" to the bottom line. The first question for any manager including the IT manager is, "Just what is the **bottom line**?" Of course, we all know the intuitive answer, "how much money we've spent and/or how much money we have?" Anybody who balances his or her own checkbook knows this. But how do we put this into language that both a CFO and a CIO can understand?

What is an Income Statement?

All for-profit organizations need to define and measure the profit they make (or don't make). The income statement is the most direct way a corporation can express this. How does an income statement present this profitability picture? It starts with a company's **revenues**: how much money has come in the door from its operations. Various **costs**—from the costs of making and storing its goods, to depreciation of plant and equipment, to interest and taxes—are then deducted from the revenues. The bottom line—what's left over—is the **net income** or profit.

Consider the following income statement for Acme Widget Corporation.

Retail sales	$ 2,000,000
Corporate sales	$ 1,000,000
Total sales revenue	**$ 3,000,000**
Cost of goods sold	$ (1,500,000)
Gross profit	**$ 1,500,000**
Operating expenses	$ (800,000)
Depreciation expense	$ (50,000)
Earnings before interest and taxes	**$ 650,000**
Interest expense	$ (110,000)
Earnings before income tax	**$ 540,000**
Income tax	$ (300,000)

Net income	**$ 240,000**

Without going into details on each term, the bottom is just that. The Acme Widget Company earned a profit (net income) of $240,000. So if you're the CIO of Acme Widget Company pitching a big IT project, chances are you don't want to submit a projected budget for $300,000. This is not rocket science.

However, the real item of interest here is not just the "bottom line" but also two of its contributing items, the key items named "costs of goods sold" and "operating expenses". If you notice, the $1,600,000 next to **costs of goods sold** is listed in parenthesis. This means this number is one of the items subtracted from "gross profit". In other words, it determines how much it "costs" to produce its widgets. If the company uses technology to make its widgets, like a computerized stamp press machine, this may contribute to the total costs of making the widgets. But most likely any "IT" in this case would fall under **operating expenses**. Operating costs differ from "Costs of goods sold" in that it is defined as the costs of business not directly a part of simply manufacturing widgets. It does not include "widget stuff" or other raw materials, or the direct labor costs of whoever runs the machinery. Operating costs do define just about everything else including administration, rents, sales, marketing, and, usually IT.

Keep in mind, although most accountants try to follow a general standard known as Generally Accepted Accounting Principles (GAAP), there is still a notable amount of interpretation involved in deciding what items go where (as you're probably keenly aware if you've been following the latest headlines...). The "operating expenses" side of the income statement becomes increasingly important in a tight economy because this is usually the first area that managers look to when "improving corporate health". Decreasing "costs of goods sold" usually involves complexities such as reorganizations and reevaluating supply and value-chains.

Not only is it important to make a profit, it usually important to show that profits, i.e., earnings, are increasing. For instance, if sales are flat, or have even declined, reducing operating expenses is one way of making sure profits do not decrease. Hiring less people, speeding up retirement incentives, or general lay-offs, usually, but necessarily, does this. By reducing salaries of "non-essential" personnel, those costs saving reduce operating expenses immediately.