

FORETHOUGHT ACCOUNTING

So You Think You Understand Revenues

by Robert Shaw and Vincent-Wayne Mitchell

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Revenue is one of the most misunderstood, mismanaged, and neglected measures in business. Consequently, many executives still rely on gut feel, rather than on hard data, to make revenue decisions—often destroying value in the process. We've seen this happen in the dozens of companies we've studied.

Consider the short shrift revenue gets on accounting reports, and the fallout that can result. In a typical weekly or monthly report, for every revenue inflow there are very many more figures on costs, assets, and liabilities. What's more, it's not uncommon to see as the only explanation for revenue entries such vague notations as "negative consumer attitudes in our sector" or "disappointing retail support" or "increasing competitor activity."

Comments like those are so general that the managers reacting to them can miss the true sources of revenue variances and end up at cross-purposes with one another. An advertising campaign intended to combat negative attitudes instead merely raises consumer expectations and increases dissatisfaction. A price promotion inspired by the pursuit of "retail support" undermines the premium positioning of the brand and erodes profits. A line extension or package redesign, in response to "competitor activity," only increases costs and cannibalizes sales revenues from the current product range.

You may think that your company, at least, has a handle on revenue basics. But ask yourself these questions: How much does it cost to drive up revenues in your firm by 1%? Which factors—advertising, sales promotions, direct marketing, product innovation—have the biggest effect on revenue growth? If no one can answer in detail, your company lacks basic revenue numeracy.

To understand and manage revenues, companies need a solid grasp of three types of revenue numbers. *Status* numbers tell managers about the sources and size of revenues for each product, customer, and sales team. *Response* data describe how revenues rise or fall in response to changes in such

factors as price, product features, or advertising. *Limit* data demarcate the limits on demand for products when consumer appetites become satiated, fashions change, or spending power is exhausted.

Companies often assume that the armies of accountants and sophisticated technologies they bring to bear on costs can also illuminate their revenues. But revenues and costs behave fundamentally differently. Costs are active; they directly cause future effects. The relationship of volume to cost of goods is generally linear, and most management accountants tend to use linear equations in calculating cost-volume relationships.

In contrast, revenues are the passive (and often indirect) result of past activity, so understanding them involves looking back in time at the many events that influenced current sales and the nonlinear relationships that govern them. For example, an initial 10% increase in spending on marketing may drive only a 1% increase in revenue, and continued 10% increases will not necessarily yield subsequent 1% increases. When diminishing returns come into play, the nonlinear shape of the investment-versus-revenue graph—the saturation curve—is critical in determining the ideal amount to spend to maximize profits.

To fully understand their revenues, companies should recruit skilled financial-modeling and econometrics specialists. Chances are this capability doesn't reside in-house. Don't give the analysis to someone who lacks specific experience in revenue accounting—and expect to pay a salary commensurate with experience, namely six figures. Just as important, train board members, as well as senior and middle managers, in the basics of revenue measures. Your new modeling specialists can deliver detailed revenue reports, but the people who make strategy must know how to use them.

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