

Testing the Top Line

Analyzing a company's sources of revenue can bring insights into growth.

[Joseph McCafferty](#), CFO Magazine

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Most companies don't really manage top-line growth. They allocate resources to businesses they think will be most productive and hope the economy cooperates. But a growing number are taking a less passive approach, and studying revenue growth more carefully. They argue that quantifying the sources of revenue can yield a wealth of information, which results in more-targeted and more-effective decision-making. With the right discipline and analysis, they say, growing revenues can be as straightforward as cutting costs. Some companies go so far as to link the two efforts.

"The idea is to bring the same systematic analysis to growing revenue that we have brought to cost cutting," says Franklin Feder, vice president of analysis and planning at aluminum giant Alcoa Inc.

To that end, Alcoa uses a sources-of-revenue statement (SRS) that was developed by Michael Treacy, author of *Double-Digit Growth* and co-founder of consulting firm GEN3 Partners, in Boston. The information on revenue captured by traditional financial statements is woefully inadequate, argues Treacy. True, he says, sorting revenues by geographic market, business unit, or product line tells you the source of sales. But it does not explain the underlying reason for those sales. "If you look at what most companies have on revenue reporting, it's pathetic," he says.

Treacy's model breaks revenue into five categories:

1. Continuing sales to established customers (known as base retention).
2. Sales won from the competition (share gain).
3. New sales from expanding markets.

4. Moves into adjacent markets where core capabilities can be leveraged.
5. Entirely new lines of business unrelated to the core.

The basic method of compiling the SRS is fairly straightforward (see "How to Create an SRS," at the end of this article); most of the information needed is readily available. But the effort does require two estimates: an accurate measure of how fast the market is growing, and customer churn rates. Treacy says the extra work involved in producing these estimates is worth it. When companies look at the amount of revenue coming from each source, and the changes in each, they can spot opportunities or weaknesses and allocate resources more effectively. "It really becomes powerful when you get down to the business-unit level," he says.

The basic problem with the traditional way of viewing revenue is that it doesn't carve out how much is produced by growth in the overall market. "You should know how much revenue is coming just for showing up," says Adrian Slywotsky, vice president at Mercer Management Consulting Inc. and co-author of *How to Grow When Markets Don't*.

He explains that companies that don't understand that their revenue growth is coming only from market expansion can be lulled into complacency. And once their market matures and growth slows, they're left unprepared. "Companies in general could do a better job of measuring revenue," he says.

As Go Costs

Alcoa is deploying Treacy's model within all of its 30 business units. The move is the latest in a program started in 2001 to focus on profitable organic growth. "We have always been obsessed with cutting costs," says Feder. "Now we are trying to bring that same discipline to growing revenue." (Alcoa is also in the middle of a \$1 billion cost-cutting plan.)

Its new revenue discipline starts with a look at year-over-year growth in the five categories for each business unit. While estimates of market growth and churn rates are readily available for some units, the figures for others require a combination of internal and outside research. Feder says the statements are generated by a team made up of

marketing and finance personnel working at the business-unit level, and that some unit managers now use the information on a quarterly basis.

However, Alcoa's approach doesn't end there, as the company is applying its SRS not only to revenue but also to margins. "It's not enough to simply grow revenue organically — we want to grow where we are most profitable," says Feder.

To do that, the company leverages the work it has done in activity-based costing, which enables it to allocate costs and revenues to different market and customer types.

Slywotsky says linking costs and revenues in this way is critical. "Trying to run cost and revenue management independently can be very risky," he warns. Companies that do so, he says, may not know whether they are cutting costs the customer doesn't care about or cutting into the ability to create growth.

Linking the two efforts requires some tricky data-integration attempts. Alcoa is tying its SRS program into the rollout of its new enterprise-resource-planning system based on the Oracle platform. The system will help make complex determinations of where markets overlap and customers are common to multiple units. "It requires a lot of data manipulation," concedes Feder, but, he insists, the results will be "very powerful."

Although Alcoa's program is still in its infancy, Feder says the company already has a better idea of its true sources of growth, and business managers can make better decisions about where to allocate resources. The company hasn't yet decided to tie the model to compensation, which would be the logical next step. For example, Treacy says, salespeople could be compensated more for growing market share than for market growth. "It could also be used to encourage customer retention," he says.

Alcoa isn't the only company delving deeper into revenue growth. First Data Corp. has been analyzing it since 1998, and credits its analysis with helping drive the company's growth at an average double-digit rate for the past five years. "We needed to understand the components of growth to decide where to devote resources," says CFO

Kim Patmore. The company uses a similar breakdown to Alcoa's, although it includes revenue growth from acquisitions.

One thing the company has learned from its analysis is that in some cases, it can derive more top-line growth by focusing on current customers than by chasing new ones. "We spend a lot of time studying customer-retention rates," says Patmore. "Sometimes it's better to polish the apple you have than to reach for the shiny one on the tree."

Accurate estimates of market growth and customer churn rates aren't always easy to obtain, as First Data and Alcoa have found. While some of the necessary data is available through Nielsen market reports, First Data relies on its corporate-research group for the rest. For some units, the group creates daily reports on trends in the market and information on customers.

Less Disclosure

Companies disclose little of this information to the public, but that reticence has less to do with a desire to keep it from competitors, as one might assume, than with regulatory concerns. First Data, for instance, once shared its revenue analysis with investors but no longer does, as a result of new Securities and Exchange Commission rules. "We moved away from talking about it to investors due to the new accounting rules for non-GAAP measures," explains Patmore. The rules would require the company to reconcile the numbers to GAAP earnings, which could be risky, since they include estimates of market growth and churn rates that could be questioned.

Now First Data's SRS reports are used primarily for annual budgeting decisions and long-term planning. In fact, Patmore says they have become a key component of the company's five-year growth plans. First Data also uses the model to decide whether acquisitions will produce enough growth to justify the cost. "We're trying to access what really moves the needle," says Patmore. A small acquisition in a high-growth segment may seem like a no-brainer, but close revenue analysis can show it to be not sufficiently meaningful if the overall market opportunity is too small or crowded. While evidence of success is hard to come by, First Data has averaged a growth rate of 10 percent since it began compiling sources of revenue data in 1998. Like Alcoa, First Data has yet to use the model as a basis for incentive compensation.

Treacy envisions a time when companies spend as much time analyzing revenue as they do costs, and when revenue accounting focuses on more than when revenue is recognized. "It's not going to happen overnight. After all, cost accounting has a 100-year head start," he says. "It's convenient to blame the market when things don't go well," he adds, "but it's not fair. Revenue growth is controllable."

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How to Create an SRS

To product a sources-of-revenue statement, five steps are required in addition to establishing total revenues for comparable periods, as is commonly done for purposes of completing an income statement or a P&L.

1. Determine revenue from the core business by establishing the revenue gain or loss from entry to or exit from adjacent markets and the revenue gain from new lines of business, and subtracting this from total revenue.
2. Determine growth attributable to market positioning by estimating the market growth rate for the current period and multiplying this by the prior period's core revenue.
3. Determine the revenue not attributable to market growth by subtracting the amount determined in Step 2 from that determined in Step 1.
4. To calculate base retention revenue, estimate the customer churn rate, multiply it by the prior period's core revenue, and deduct this from the prior period's core revenue.
5. To determine revenue from market-share gain, subtract retention revenue, growth attributable to market positioning, and growth from new lines of business and from adjacent markets from core revenue. —*J.McC.*

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