CHAPTER 1

What Is Revenue Management and Why Is It Important?

Revenue management has been an area of practice for about 30 years. However, it has made few inroads into the general management literature or particularly into the accounting and finance arena. This book brings together much of the work on revenue management to date and discusses it from a financial analysis perspective. Revenue management should be a part of the focus of any executive; the analysis techniques should be in any financial manager's toolkit.

One common approach to achieving revenue growth is to buy it—that is, via *mergers and acquisitions*. Indeed, revenue growth by acquisition has been the strategy of many companies. Although acquisition is a valid approach, it is not the focus of this book. We consider techniques for revenue growth by building the sales base of the existing organization and measuring the success of that activity.

Revenues are the lifeblood of the organization. Without adequate revenues, an organization cannot cover its costs and sustain itself. Revenues are also the key to organizational growth, by enhancing and expanding the customer base. Thus, a focus on managing the revenue function is critical for organizational success.

The primacy of revenue management is emphasized by Bouter in his recent book, *Pricing: The Third Business Skill.*[1] He identifies the first critical skill for a successful business as creating a product or service, and the second as selling that product or service. The third critical competency is pricing that product or service to achieve sustainable profitability.[2]

What Is Revenue Management?

Revenue management encompasses differential pricing and other techniques to influence customer demand for an organization's products and services.[3] As discussed in detail in Chapter 2, revenue management began in the airline industry strictly as differential pricing, and then expanded to other industries—initially in the travel and tourism fields—with economic characteristics similar to those of airlines. Eventually, both the techniques employed and the range of industries expanded, to the point where revenue management is now applied in a wide variety of organizations.

Business strategy expert Michael Porter suggests that firms compete in one of two ways: (a) by running a low-cost operation and offering low prices or (b) by *differentiation*, featuring a variety of product and service features that necessarily command higher prices.[4] Walmart and discount airlines fall in the first category; they compete on the basis of low prices but with some limitations as to the quality of merchandise, range of services, amenities, and the like. Brooks Brothers, Mercedes-Benz, and Tiffany are examples of companies that can differentiate their products and services as having superior quality and features. One may describe this framework as *strategic pricing*—the decision by a firm on where to position itself along the low-cost versus product differentiation scale. Within a strategic pricing framework, firms still have the task of establishing and managing the pricing of individual items; this latter task is the realm of revenue management. Thus, revenue management is concerned with optimizing pricing at the operational level.

Economics suggests that, in competitive markets, prices are set by the interplay of supply and demand: Companies do not set prices; the *market* sets them. The stock exchanges are certainly an example; the interplay of buyers and sellers establishes the market price, and potential market participants decide whether they are willing to transact at the specified price. Other auction markets, such as eBay, also operate in this manner. In most business environments, however, the sellers set the price. Even in situations that would seem to be nearly perfectly competitive—the price of gasoline in a community or the price of a gallon of milk at a retail store—we observe variation among sellers, suggesting that revenue management decisions are at work. In some cases, the supply–demand

approach to pricing is viewed negatively, as in the case when retailers substantially increase the price of essential products during a hurricane or blizzard. The latter situation suggests that revenue management is not merely an internal function but also one that takes the short-term and long-term reaction of customers into account.

In the long run, prices need to cover costs and provide a satisfactory return on investment. On a day-to-day operational basis, however, many decisions need to be made in pricing, promotions, and product offerings. Revenue management provides the theory and the oversight structure for these activities.

Pricing and Revenue Management

Price setting is one of the key dimensions of revenue management, with the ultimate objective being profitability. Consider the following three-part relationship:

Prices → Revenues → Profits

The linkage between prices and revenues is *volume*. How much can be sold at given prices? Generally, lowering the price will increase volume, though it may or may not increase revenues. Similarly, raising the price will usually decrease volume, but it may or may not decrease revenues. We discuss *price* elasticity, the relationship between price changes and volume changes, in Chapter 7.

The linkage between revenues and profits (income) is *expenses*. What are the costs of generating these revenues? Expenses consider not only the costs related to volume changes—providing more (or less) of one's products or services—but also the direct and indirect costs of the revenue management actions themselves. Discounts, promotions, and other revenue management techniques involve both short- and long-term costs. A significant—and difficult to measure—cost is customer reaction. We discuss customer reactions in Chapter 6.

The revenue management function involves the simultaneous consideration of all three elements: prices, revenues, and profits. Setting prices has become a complex area, one that merits the attention of top

management. Price setting should also be on the radar screen of financial managers, who are best positioned to analyze the effects of price changes on profits. Revenue management decisions may have both short- and long-term effects. A decision that appears good in the short term may have negative long-term consequences. Both need to be considered, but assessing long-term effects is more difficult.

The Role of Marketing

One may ask, "Is revenue management not the role of marketing management?" Certainly, because marketing deals with issues of pricing, promotion, channel selection, product mix, brand management, and the like. Marketing management initiates, and is the expert in, many of the techniques for generating sales. However, the task is not simply to generate more sales. The task is to generate more sales in ways that enhance the current and long-term profitability of the enterprise. At this point, the role of marketing and financial management must be balanced. Financial management must analyze whether revenue enhancement measures will likely be profitable. A look at some of the industries that have been major proponents of revenue management shows the relevance of linking revenue growth to profit growth. The airline industry was the originator of revenue management in the form of differential pricing; yet most firms in that industry chronically struggle with profitability. The automobile industry has also been a heavy user of revenue management techniques. Auto manufacturers and distributors have used rebates, special financing, and other differential pricing tactics as revenue management tools. This industry has similarly struggled historically with profitability. Clearly, knowing how to build sales is only a part of the challenge; one needs to build sales *profitably*. The old humorous saying that "we lose money on every transaction, but we make it up on volume" is applicable here. Although this may sound convincing, it has never been a prescription for success.

Relation to Cost Management

Cost management has long been a recognized field in accounting and finance. The roots of cost accounting go back to the earliest days of the

Industrial Revolution, as techniques such as product costing and standard cost systems were developed and refined. Cost *accounting* has evolved into cost *management* over the past 25 years as new techniques such as activity-based costing, target costing, and throughput analysis were introduced and gained significant acceptance. Though revenue management deals with the *other half* of the income process, it has received much less attention than cost management.

Cost management has its foundations in industrial engineering and in the pioneering works by major companies. Later techniques tended to come from academics, consultants, and international (especially Japanese) practices. As a result, cost management has become an integrated and significant aspect of financial management. In recent years, cost management has expanded into the concept of *supply chain management*, looking at costs not only within the firm, but also along the entire supply chain from raw materials to finished products to follow-up services and support.

Revenue management had its foundations in the practices of one industry and then spread to other industries with similar economic characteristics. Much of the literature is found in the operations research field, where revenue modeling is common, and in the journals of specialized industries, primarily the travel and hospitality industries. Though revenue management has obvious implications for financial management, its presence, to date, in the accounting and finance literatures is minimal. Revenue management may be viewed as the complement of supply chain management. While the latter involves a firm's interaction with its suppliers, revenue management involves the interactions with customers.

Managing the income-generating processes of the organization is a key task of management, in general, and of financial management, in particular. It requires an understanding of both cost management and revenue management.

Revenue Growth versus Cost Reduction as a Strategy

Cost management tries to enhance income through cost reductions; revenue management seeks to enhance income through sales growth. Is there a best way to enhance income, both in the short term and in the long term?

The message of the importance of revenue growth has been proclaimed for many years. A 1996 *USA Today* article reported on a survey of 150 executives of Fortune 1000 companies by Deloitte & Touche.[5] Cost reduction, or reengineering and restructuring, was said to be *out* while getting bigger was *in*. Revenue growth of more than 15 percent annually from 1989 to 1994 was associated with employment growth of 1.6 million jobs, while revenue growth below 5 percent annually was associated with employment declines of 2.9 million jobs. Clearly, revenue growth and cost (employment) reduction did not go together, though it is not clear which was the cause and which was the effect. A 2001 *Wall Street Journal* article observed that one should focus on the value (revenue) created by labor, not just the cost of labor. Companies need to assess the extent to which employees enhance product quality, value, or customer service.[6]

Although this message has been delivered for years, there is still a strong tendency toward cost reduction. In a 2010 *Newsweek* cover story, Professor Jeffrey Pfeffer from Stanford University comes out strongly against layoffs, perhaps the most common form of cost reduction employed by organizations.[7] His lead example relates to the airline industry immediately following the attacks of September 11, 2001. Flights were initially suspended, and upon resumption, airlines were faced with considerable passenger reluctance and a weak economy. All U.S. airlines but one announced layoffs numbering in the tens of thousands. Southwest Airlines, the only domestic carrier to forgo layoffs, has subsequently succeeded where competitors have faltered. Pfeffer points out that Southwest is "now the largest domestic U.S. airline and has a market capitalization bigger than all its domestic competitors combined."[8]

Professor N. J. Mass from Harvard University found that, even though cost reduction initially seemed more valuable, revenue growth is likely to have a stronger long-term impact.[9] In the short term, the appeal of cost reduction is that nearly 100 percent of the cost savings can drop to the bottom line as improved net income, assuming that cost reduction does not impact sales. Depending on the industry, as little as 7 to 10 percent of enhanced revenue may show up as income, provided the revenue growth has not come at the expense of prices and profit margins.

Mass notes that in the longer run, there is a limit to cost reduction, and companies can only cut so far. In contrast, revenue improvements tend to compound over time, such that 1 percent of margin improvement achieved through cost reduction is almost equal in value to 1 percent revenue growth that persisted over time. His research further suggests that, over time, one percentage point of revenue growth could enhance firm value as much as 6 to 10 percentage points of margin improvement driven by cost savings.

Empirical market research has tended to support Mass's conclusions about revenue growth. Studies have found that investors react more positively to revenue growth than to cost savings.[10] This response was especially pronounced for growth companies, since investors reacted negatively if revenues declined, even if profits had increased due to cost reductions.[11]

In 2007, prior to the financial meltdown, a *Wall Street Journal* story about Citigroup indicated investors' and analysts' desire for the company to show higher revenue growth.[12] In 2004, Coca-Cola Enterprises attributed its higher profits to revenue management techniques, such as rate increases, contributions from package mix, and volume growth.[13]

Business experiences also bear out the importance of revenue growth and the dangers of cost cutting. In 2007, electronics retailer Circuit City announced that it would cut costs by laying off its 3,400 highest-paid sales associates. Presumably, these individuals were also Circuit City's most experienced and most successful sales personnel. Customers were frustrated to find fewer and less knowledgeable sales personnel in the stores in a business where technical advice and assistance are critical to selling the product. Sales rapidly declined; Circuit City filed for bankruptcy in 2008 and closed all its stores the following year.[14] Clearly, cost cutting failed as a strategy for Circuit City. The impact of the cost cutting was strongly felt by customers, and the impact on revenue was devastating.

Harvard professor Zeynep Ton found that maintaining or expanding retail staffing, even in the face of declining sales, contributed to higher profits. His study of 250 stores over four years found that improvements in making sure merchandise was on display and not in the storeroom, and in returning obsolete goods to suppliers both increased profits. Cutting staff often meant that these tasks were shortchanged.[15]

McKinsey & Company consultants Michael Marn and Robert Rosiello, in a 1992 *Harvard Business Review* article, reported the profit effects of a 1 percent change in each of the four components of operating profit—price, volume, variable cost, and fixed cost—given that other components remained unchanged. Based on average data for over 2,400 companies, they concluded that a 1 percent increase in price (with no volume decrease or cost changes) would have the largest effect, an operating profit improvement of 11.1 percent. A similar decrease in variable cost, on average, would increase operating profit by 7.8 percent. Less effective would be 1 percent growth in volume (yielding a 3.3 percent operating profit increase) and 1 percent decrease in fixed cost (2.3 percent operating profit increase).[16] Their research clearly establishes revenue (price) management as critical to profit improvement.

Michael Treacy, in *Double-Digit Growth: How Great Companies Achieve It—No Matter What*, states that most companies know how to cut costs, but fewer know how to consistently grow revenues.[17] He further points out three key cycles for a company's success. One is *economic*, that is, a growing company tends to have better financial results and lower capital costs. The second is *momentum*, that is, a growing company attracts attention and builds customer confidence. The third is *opportunity*, that is, growth leads to new products, new employment, and higher morale.[18] Companies on the upside of these cycles will usually prosper, whereas those on the downside often decline further. The company that is actively growing its revenue is likely to be on the upside of these cycles, whereas a company focused on cost cutting is more likely to experience declining economic results, slowing momentum, and diminished opportunity and morale. Again, the message is that revenue growth, rather than cost reduction, is the key to long-term success.

Indications from all sources suggest the importance of revenue management, and its likely advantage over cost reduction, in achieving long-term financial success. But revenue management often takes second place to cost cutting as a response to inadequate profits. The most common form of cost cutting is reduction of personnel. As illustrated earlier, both research and anecdotal evidence suggest that cost cutting may give a short-term profit boost, but it can diminish customer service and endanger the company's future. It is critical that the financial executives be aware of and

knowledgeable about revenue management techniques to properly guide the company, both in good times and bad.

Role of Financial Analysis

Financial analysis techniques play an important role in implementing and evaluating revenue management. These techniques help analyze strategies in advance and provide a guide to making efficient decisions with regard to revenue issue: “What is the likely impact on revenues and profits, both short term and long term?” Financial analysis also reports and analyzes the success of revenue management initiatives after implementation: “Were the expected outcomes realized?”

Accounting information is a key source of detailed information for the analysis of revenue management initiatives; data involving various dimensions of each transaction need to be captured at the transaction point.

Various techniques are used to analyze the expected outcomes of revenue management approaches. Such techniques, drawn from management accounting, economics, and other areas, are reviewed in Chapter 3, and are incorporated throughout the book.

Overview of the Book

Following this introductory chapter, Chapter 2 discusses the origins and development of revenue management, its early applications in a few industries, and its subsequent application in a broader range of contexts. Chapter 3 introduces some of the financial tools needed to analyze revenue management proposals and to help decide if the ensuing growth in revenue will be profitable.

Chapter 4 begins a discussion of the broad field of pricing, the key to revenue management. Chapter 5 discusses and analyzes various revenue management techniques. Chapter 6 explores the field of customer reaction to revenue management.

Chapter 7 presents some additional financial and economic tools for the analysis of revenue management decisions. Chapters 8 and 9 discuss two relatively recent management concepts with special relevance to

revenue management. The Computer Aided Manufacturing-International (CAM-I) capacity model, discussed in Chapter 8, integrates an understanding of an organization's capacity and its deployment to the potential for revenue generation. The theory of constraints, explored in Chapter 9, also integrates well with revenue management via the focus on growth of throughput.

Chapter 10 presents the concept of customer value, and Chapter 11 discusses how to determine the value of customers. Chapter 12 summarizes some of the techniques for analyzing and making revenue management decisions, including the role of revenue management in difficult economic times, when pressures for cost reduction often dominate. Chapter 13 concludes exploration of some emerging topics and comments on the future of revenue management.