

Revenues, Revenue Variances and Customer Profitability Analysis

Objectives

- 1 Distinguish between revenue tracing and revenue allocation;
- 2 Show how broad averaging of revenue adjustments can result in misstatement of product, service, or customer revenues;
- 3 Describe two methods of allocating the revenues of a bundled package to the individual products in that package;
- 4 Describe the insight gained from dividing the sales-volume variance into the sales-mix and sales-quantity variances;
- 5 Explain how market-size and market-share variances provide different explanations for a sales-quantity variance;
- 6 Discuss why explicitly recording the amount of price discounting provides insight into customer revenue and customer profitability;
- 7 Show how customer-profitability reports can be prepared to highlight differences across customers in their profitability;
- 8 Explain how the cost hierarchy notion can be applied to customer costing.

1 Revenue Analysis

Revenue Tracing

Revenue tracing occurs where revenues can be identified with an individual product (service, customer, and so on) in an economically feasible (cost-effective) way.

- ❖ Investments in information systems that allow for proper revenue tracing leads to accurate product revenues and product profitability reporting.
- ❖ Sales return adjustments done with broad averaging may result in inaccurate net revenue figures
- ❖ Recent advances in information technology has permitted better matching of sales returns to individual products.

Revenue Allocation

Revenue allocation occurs when revenues, related but not traceable to individual products are assigned to those individual products.

- ⊗ A bundled product is a package of two or more products or services, sold for a single price, where the individual components of the bundle may also be sold as separate items, each with their own stand-alone prices.
- ⊗ When individual departments or division managers have revenue or profit responsibilities an important issue is how to allocate the revenues from bundled product sales among the individual products in the bundle.

Stand-alone Revenue-Allocation Methods - use proportion of individual product selling price, cost, or units in bundle to total of all products in bundle to allocate revenues

Unit Selling Prices

Unit Costs

Unit Based

Incremental Revenue-Allocation Method - ranks individual products in a bundle and then uses this ranking to allocate the bundled revenues to these individual products

- ⊗ The primary product is the product ranked first in the bundle. It receives an allocation equal to its stand-alone price.
- ⊗ The incremental product is the second, third, and so on product in the bundle. It receives its revenue allocation following allocation to the primary product.
- ☹ Designation as the primary or incremental product has significant implications for revenue recognition and profitability of the different products.

2 Customer Profitability Analysis

Customer profitability analysis examines how individual customers, or groupings of customers, differ in their profitability. This is a relatively new topic in management accounting, but a vitally important one.

- ☞ **Customer revenues** are inflows of assets from customers received in exchange for products or services being provided to those customers.
- ☞ **Price discounting** is the reduction of selling prices below listed levels in order to encourage an increase in purchases from customers. Keeping separate track of price discounts in the accounting records may provide key insights regarding their use.

Customer Costs

Allocate All Costs to Individual Customers - the sum of customer profits will be the same as total profitability of the company. An activity-based costing system can provide information which explains why some customers are profitable and others aren't.

Customer-Profitability Profiles - Ranking customers on operating profits generated from sales to them or based on customer revenues with cumulative revenues for all customers may provide some useful information.

Customer-Cost Hierarchy - categorizes costs related to customers into different cost pools on the basis of either different classes of cost drivers or different degrees of difficulty in determining cause-and-effect (or benefits received) relationships.

Seven levels of costs are identified:

- 1 Enterprise-related activities
- 2 Market-related activities
- 3 Channel-related activities
- 4 Customer-related activities
- 5 Order-related activities
- 6 Parts-related activities
- 7 Direct materials