

## **“Balancing’ the Income Statement”**

Accountants often use the references to the “Top Line” or “Above the Line” and the “Bottom Line” on an Income Statement to distinguish between Revenues and Profit. In periods of prosperity like that experienced in the decade of the 90’s, companies tend to overemphasize revenue growth at the expense of profitability. The Dot.Com graveyard is filled with the headstones of Corporate executives who focused so heavily on revenue growth or the projections of revenue growth by market research firms that they could never define a route to profitability. Conversely, in contracting economies, companies try to generate profits by cutting costs through downsizing. During the 1980’s and early 1990’s a great many large companies relied heavily on their CFO’s to orchestrate their profitability. What the CFO’s knew how to manage was costs, and they often were not aware of the extent to which they were mortgaging their companies’ futures, by eliminating expenditures essential for change and growth. Many smaller companies rely on their accountants for similar financial advice. Less sophisticated accountants focus exclusively on expenses that they can control without fully understanding the impact on the company of reducing expenditures in critical areas. In both cases, growth in revenues without corresponding growth in profits, or growth in profits without corresponding growth in revenues, the result is the same--- short term success, long-term disaster. The key to managing a successful business is balancing revenues and profitability, so that each is growing proportionately.

In a book published by Free Press in 1995 called *Grow to be Great*, authors Dwight Goerz and Joao Baptista categorized Fortune 1000 companies into four sub groups: “shrinkers,” “cost-cutters,” “unprofitable growers,” and “profitable growers.” Goerz and Baptista demonstrated that the stock market placed a much higher value on companies whose profit growth was generated by revenue growth than those whose profit growth was generated by cost-cutting. They concluded that “In the stock market a penny earned is a lot more valuable than a penny saved.” The market recognized that once cost-cutters run out of fat to trim, they have little chance of producing future profits.

For companies to grow they must change. The challenge faced by most small companies is how to provide incentives for leading change. For publicly traded companies, the process of making stock options available at fairly deep levels within the company was supposed to provide this type of motivation. Equity in the company should provide incentives among all affected employees to contribute to the company’s prosperity.

Often, however, the employee’s behavior is governed by what is required to obtain additional options, which does not always correspond to what was required to generate long term growth. And when the stock price falls below the option price, the incentives become counterproductive. Employees who believe that their options will expire as worthless, have lost their incentive.

The simplest incentive for publicly traded companies, or for the smaller privately-held businesses that constitute our client base, is pay for performance. Pay for performance is a

concept easily applied to sales, but it is more difficult to apply to other operations. That is why often pay for performance programs generate *increased revenues at the expense of profitability*. Sales commissions paid on the volume of sales do not assure profitability. They may in fact lead to under pricing or acceptance of inherently unprofitable orders. Similarly, pay for performance is often misapplied exclusively to measurable cost reductions --- that can adversely affect over-all profitability by requiring rework or decreasing quality.

Instead management and the financial consultant must identify and devise means to quantify innovations which minimize waste and increase productivity without reducing quality. True increases in productivity provide capacity for an increase in volume and revenues, while at the same time providing a basis for enhanced profitability. The challenge for management and management consultants is to reward directly those activities which are innovative, which are what the Japanese call *kansai*, "*continuous improvement*."

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*Editor's Note --- Tom is the Partner in Charge of the Firm's Hermitage Office and is using his management consulting skills for "continuously improving" the growth and profitability of his business clients. Tom is indebted for much of the information in his article to an article in the September/October 2001 issue of Corporate Finance published by Warren Gorham Lamont. The article is entitled, "Profitable Growth for Every Company," by Reed Taussig*