What Is Revenue?

Description

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Do you routinely scour the stock market for new companies to add to your investment portfolio? If so, you're likely familiar with the term *revenue.* Even if you're a newbie in the world of [self-directed investing](), you at least have a vague notion that this term refers to the amount of money a firm makes.

Still, the concept of revenue can get hazy at times and can elicit confusion. What does it mean precisely in the context of business? Is it synonymous with the cash a company receives from customers? And how does it relate to income?

Let's dig in and learn about revenue in detail.

What is revenue and how do firms calculate it?

Revenue is the money a company generates from selling its products or services to customers. Revenue, also referred to as sales, can be found at the top of a company's income statement.

Firms calculate revenue in different ways, depending on the industry they operate in. For example, a retailer multiplies the number of units they sell by the average sales price charged to each customer to figure out their revenue. A legal firm determines revenue by multiplying their hourly fee by the number of hours they work.

Revenue calculation can be tedious and complex at times, especially for companies involved in construction and manufacturing. However, revenue is simply the amount a company earns from its goods and services at the most fundamental level.

How is revenue measured and recorded?

Surprisingly, measuring revenue can be tricky. The reason is that specific accounting standards dictate when activities and transactions can be considered revenue and when they can't. The complexity depends on the accounting method a firm utilizes to measure and record revenue. There are two methods available: accrual accounting and cash accounting.

Under accrual accounting, the company must deliver the product or service to the customer before recording the activity as revenue. Suppose it receives cash up front but had not yet fulfilled its end of the bargain. In that case, they're unable to record the transaction as revenue. This feature of accrual accounting is called the revenue recognition principle. It states that a firm can only recognize revenue when realized and earned, either cash or on credit.

Publicly traded firms in Canada must observe accrual accounting rules set forth by the Accounting Standards Board (AcSB). However, many private firms also apply accrual accounting in their financial recording-keeping and reporting practices.

Under cash accounting, a company recognizes revenue only when they receive cash from a customer. Small businesses and freelancers typically use this accounting method to simplify revenue (and expense) tracking.

How is revenue presented?

As noted above, revenue appears as the first line item on a company's income statement. A firm typically presents revenue as net of customer returns, allowances, and discounts. However, they may choose to disclose these deductions on the income statement for extra transparency.

Larger firms often subdivide their revenue according to their business segments. This level of detail makes it easier to assess how each division is performing. Revenue that doesn't originate from the firm's core business operations is included on a separate line on the income statement. These secondary sources of revenue may consist of income from short-term investments, interest charges on past-due customer account balances, and proceeds from lawsuits.

Revenue versus income

Novice investors sometimes conflate revenue with income, but there's a stark difference between the two. The former represents money a company generates from its primary business operations. The latter refers to the amount of money it earns after accounting for expenses. As a result, the amount of cash a firm receives from its sales will differ, sometimes dramatically, from its income.

When a company's revenue exceeds all expenses, it reports a profit for the reporting period. When its revenue doesn't cover all expenses, it reports a loss.

How to analyze a firm's revenue

When evaluating a firm, you should assess its revenue figures periodically, either quarterly or annually. Is revenue growing? If so, by how much each period? Is it in line with its industry average or outpacing it? When looking at the stock price, one metric you can employ to see if the firm presents an investment opportunity is the price-to-sales ratio (P/S). The P/S ratio measures the current price of the company's stock relative to its revenue. A low ratio may suggest the stock is undervalued, while a high ratio may indicate the opposite.

As vital as revenue is, you should never analyze it in isolation. Be sure also to scrutinize a company's cash flow, expenses, income, etc.

For example, suppose a company is generating substantial revenue but lacks sufficient cash reserves. In this case, liquidity issues may arise in the future, which could lead to bankruptcy. Not good.

Let's say a company's revenue growth has stagnated or is declining, which may signify that it's losing market share. However, suppose the company also engages in aggressive cost cutting and pours considerable money into research and development. In that case, revenue growth may reignite in the future and contribute to a fatter net income.

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