

## Value Point Accounting for Higher Profitability

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We have heard the phrase: “Can’t see the forest for the trees”. Accounting for business operations has a different problem: “Can’t see the trees in the forest”. The “forest” in this case is the financial performance of the entire business which is displayed through its income, balance sheet and cash flow statements. Important operating performance measures can be determined from these statements including return on invested capital and cash flow return on investment.

We can see this performance for the entire business but not the individual components that drive it, namely each product and service sold to each customer. There is a good reason for this. It can be difficult and prohibitively expensive to try to distribute each account in the income statement and balance sheet to each product or service sold. Most businesses rely on “gross profit” (sales minus cost of goods sold) to measure product and customer performance. This simple profit measure ignores the product’s specific effect on general & administrative expenses or on the various balance sheet assets and liabilities. Using just gross profit we can’t see the ROI (return on investment) on the individual products and services we are selling.

Value Point Accounting (VPA) is a low cost way to get at this ROI information and provide an advantage over competitors who manage by gross profit. Picture your business as a portfolio where each investment is a specific product sold to a specific customer. Consider every priced item on a customer’s invoice as a unique “value point” with its own return on capital. A business can readily have thousands or millions of these value points. Value Point Accounting seeks the investment performance of each value point and uses it for better business decisions.

VPA uses concepts from operations management, modern cost accounting and financial analysis to determine the total economic performance of each value point. These include the theory of constraints, capacity based costing, activity based costing, cost of quality, working capital turnover analysis and economic value. The key to cost effectiveness is to apply these concepts to a simple rather than complex business accounting structure. There is no need to explode the number of general ledger accounts or keystrokes in the

accounting department. The VPA chart of accounts is built around a handful of costing objectives that are applied to the unique characteristics of each value point.

The critical difference with Value Point Accounting is that balance sheet operating assets and liabilities are applied to products and customers along with income statement expenses. This is required to calculate economic value and ROI performance. VPA can bring out the numerous financial statements embedded in the company's products and customers. Call it "nano-accounting".

Recognizing the economic impact of net asset intensity for each product and customer can alter business decisions and strategies. Two value points may have a similar unit cash cost but quite different asset requirements. The value point using more fixed asset capacity, held longer in inventory, or carried longer in accounts receivable requires a higher price to meet the rate of return goal. VPA comprehends a value point's total economic impact on the business including how fast each customer pays invoices.

### Using Value Point Information

The Value Point Accounting approach to profitability is to:

- 1) Recover all the cash cost consumed by each value point
- 2) Earn the firm's target return on capital on the net operating assets supporting each value point.

This profit view basically means getting reimbursed by the customer for all related cash outlays and then charging the customer a profit amount sufficient to earn the firm's target ROI on the supporting net assets.

VPA can find out which products and customers do and do not earn the company's target return on capital. Accordingly, each value point resides in a performance class:

Green: Earns or exceeds the target return on capital (a value generator)

Yellow: EBITDA insufficient to earn the target return (marginal business)

Red: Does not cover all cash costs (cash consumer)

Business value can improve without additional growth or investment if the product and customer mix shifts toward green value points. Let competitors without value point visibility "win" more share of the low performing red and yellow markets while you provide better service to the green markets.

For each red or yellow value point, VPA calculates the higher unit price necessary for green status. The product marketing manager is now armed with a comprehensive financial tool.

Value Point Accounting is particularly useful in managing profitable growth. VPA can measure the *economic utilization* along with the physical utilization of existing business capacity. Economic utilization measurement answers and prompts these questions: What percentage of the existing capacity (and its related investment) is earning the target rate of return? How much of our current capacity is supporting red and yellow value points? Can we redeploy this underperforming capacity before committing more capital investment for growth? A value point review of current capacity usage can help optimize existing resources before assuming more business risk.

If the whole is the sum of the parts, look at the parts! Leading edge finance, accounting and operations management concepts can merge to measure basic business elements at a low cost. Value Point Accounting helps businesses redeploy existing resources and focus growth on higher value products, services and customers. While, of course, hoping your competitors still use gross profit!

If you would like to find out more about this innovative approach to determining product profitability please contact your local office of Scale Finance.

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