

dti

SUCCEEDING THROUGH INNOVATION

Using Value Added to grow
your business

www.innovation.gov.uk



Value Added A financial health check for businesses

How do you measure the financial health of your business?

The director, manager or company owner who is best informed about his or her operations is in the best position to manage his/her business profitably.

Financial information and financial control provide the navigation tools for the business. In its simplest form these could be gross profit and cash flow. In addition, a manager might use some simple ratios such as return on equity, gearing, and average annual growth in pre-tax profit.

However, some measures and ratios can be deceptive and lead the executive to think that the company is in better health than it is. For example, a business can make profits in the short term by letting its skills and equipment decline; or it might reduce its investment in innovation and marketing, putting at risk current and future success.

The measures proposed here are based on value added; that is, sales minus the cost of bought-in goods and services.

Value Added

Using Value Added as a key component of your financial health-check is an excellent way to start asking:

- Is value added increasing more than inflation year after year?
- How much value added the business is creating relative to its major costs of staff and depreciation, Value-Added divided by costs (VA/C). For the UK's largest companies, this averages about 1.52. In other words it takes these companies £1 of these costs to generate £1.52 of value. It is usually shown as a percentage, i.e. 152%.
- How much value added is created per employee, expressed as VA/E. For the UK's largest companies this averaged £48,000 in 2005.

These are very useful benchmarks to measure your business against. Of course, the performance of your business may vary because of its size and sector but the following table can give you a rough guide to your financial health.

VA/C %	Rough guide to financial health
175+	This is a very strong performance for most sectors.
150	The business is in a fairly healthy state, as long as it's investing enough to maintain its position, and is close to the average for large companies.
125	The business has its head above water but there's not much room for strategic investment.
100	This is very worrying. You are not even covering your basic operating costs.

VA/C can tell you two important things about your business:

1 If VA/C is low, you will almost certainly need to invest more if you want to improve, though this will be hard as you have little scope to do so. To improve the figure over the short term, you might decide to cut back on certain expenditure but you need to assess how those costs will impact on present and future value.

2 If VA/C is rising, that's generally a good sign (falling VA/C is usually a bad one). Measuring VA/C for the past 3 years and examining the trend is a very useful exercise. On its own a rising VA/C does not tell the whole story as you might have reduced investment to achieve a higher figure.

Conversely, investing for the future – leading to an improved performance later on – can cause a reduced VA/C in the short term.

The key thing is that you have made a strategic decision on investment and you have the means to measure its impact.

How do I calculate Value Added?

It's very simple and needs only the figures for costs that you would normally use.

Value added is the amount of wealth a company's activities creates:

- Sales minus the cost of bought in goods, materials and services.

It can be worked out from company accounts as:

- Operating profit + employee costs + Depreciation + Amortisation.

The Value Added Calculator will do this for you – find it at:

www.innovation.gov.uk/value_added/calculator.asp

How can I increase my Value Added?

Fundamentally, your value added is determined by your sales and the costs associated with bringing them to market. There are obviously three main ways of increasing your value added:

- Increase your sales (e.g. by developing new markets).
- Offer your customers something they will pay more for.
- Cut the costs of what you buy in to achieve those sales.

Of course, if your products and services are not profitable in the first place, driving up sales will worsen your financial health. Many companies face the dilemma of their products and services being undercut by cheaper offerings from competitors, not only in the UK but, increasingly, from abroad as well.

Innovation and Value Added

The answer to this intensive competition is innovation – the successful exploitation of new ideas.

Innovation in the products and/or services you offer:

- New or improved offerings, together with developing your brands and markets.
- Improvements to your internal business processes and customer interface.
- New ways of doing business, such as utilizing the power of the internet to cut the costs of sales, marketing and distribution costs.
- Entering new, niche markets where your offerings are possibly customized to attract a more discerning market and, therefore, warrant a higher price.

Your competitors will be trying to do the same, so the sooner you put innovation at the heart of your business strategy, the sooner you will outperform them.

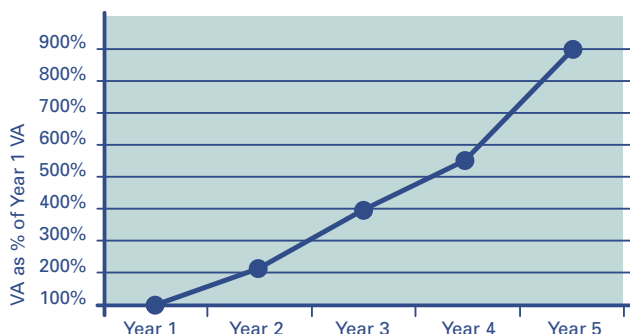
It will mean your employees may require new skills; you will need their ideas and input as to how they can become more productive; you may need to buy or lease new equipment or work with a university to acquire new technologies.

It will require investment of money, time and knowledge to succeed in the markets of the future. The cost of investment may be significant... but failure to invest might prove fatal!

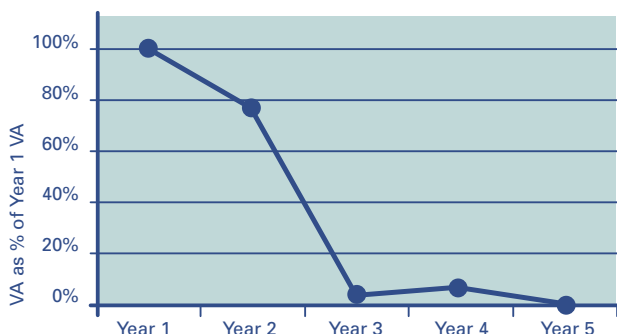
The company that invested wisely and the one that did not!

These real examples illustrate the difference between the Value Added of companies with high and low VA/C.

Value Added Growth Company
(VA/C over 160% in Year 5)



Value Added Fall Company
(VA/C just over 100% in Year 5)



The 'growth' company has VA/C of over 160%. This score is sufficient for companies in most sectors to sustain and grow the business. This one has done exceptionally well and value added has increased nearly 9 times over five years.

The 'falling' company, however, has VA/C just above 100%, and its Value Added has fallen to around 40-50% of its previous level. At this low level of VA/C, there are few options for recovery. The company may need re-financing, for example, but obtaining it would require the company to demonstrate a viable strategy for reversing its decline.

Successful companies need sustainably high wealth creation efficiency as well as the ability to increase Value Added year on year.

Have you charted your VA and VA/C for the past 5 years? What does this tell you about your business?

Further information

For further information on Value Added, and the DTI's annual value added scoreboard, go to:

www.innovation.gov.uk/value_added

For further information on Innovation, go to:

www.innovation.gov.uk

For advice on ways to improve your business across the board, contact the Business Link service on 0845 600 9006 or visit:

www.businesslink.gov.uk

