

What is Throughput Accounting?

TOC Financial Measurement vs Cost Accounting

Conventional accounting systems focus on measurements such as Net Profit, ROI and Cash Flow. These are all well and good for financial reporting, but they only allow managers to see the results of their decisions in retrospect; to run a business effectively, one needs to be able to judge the immediate and future impact of decisions. Throughput Accounting uses Dr Eli Goldratt's measurements of Throughput, Inventory and Operating Expense, which can be applied universally across the company and are easily understood by those at the cutting edge of shop floor decision making. In particular, Throughput Accounting rejects the conventional reliance on efficiencies - and in particular, labour efficiencies - which it sees as counter productive.

Since the goal of every for-profit company is to make money, the primary measurements of progress towards that goal are expressed in the same unit - money.

Throughput: The rate at which the system generates money through sales. 'Departmental Throughput' is never measured as this tends to lead to counter-productive localised policies; TOC principles are always applied holistically.

- Throughput takes into account the **time factor**: product profitability comparisons by e.g. £ per unit are inadequate - but once the number of units that can be produced per hour (for example) is determined, then Throughput for each product can be calculated.
- Money from a sale which is passed straight back to suppliers is deducted from the Throughput figure. For example, a deckchair selling for £20 and comprising £5 worth of wood, canvas and fastenings would give a contribution of £15 per unit. If 10 deckchairs can be produced **for confirmed sale** per hour, then the Throughput rate is £150/hour.
- **Finished goods inventory in storage is not counted as Throughput because it has not yet generated money by selling.**
- Labour costs are generally **not** subtracted from the Throughput calculation.

Investment: All the money that is tied up in the system. This can be broken down into two areas -

- The obvious inventory of raw materials, WIP and finished goods.
- Investments - i.e. that which is owned by the company in order to generate Throughput - e.g. premises, machinery, fixtures and fittings etc.

Operating Expense: All the money the system spends in order to convert Inventory into Throughput.

- This includes all regular labour expenses.

Once the correct figures for T, I and OE have been calculated, the measurements can be used throughout the company to accurately predict the global effect of local, departmental decisions - for example, Profit = T-OE, Return on Investment = T-OE/I, Productivity = T/OE and Cash Flow = T-I-OE.

Conventional cost-cutting methods can, in theory, reduce Inventory and Operating Expense to nil - at which point a business ceases to exist! Throughput, however, can be grown indefinitely - and it is to this end that the fundamental TOC principle of identifying, exploiting and elevating the system constraint (the 'Five Focusing Steps') in order to maximize flow is devoted.

Effectiveness, not 'Efficiency'

The measures used by Throughput Accounting ensure that all decisions are focused on the ultimate goal of the company (i.e. to make money now and in the future). With conventional Cost Accounting, local efficiencies are all important - but this mind-set only leads to the excess production of inventory, which - as Throughput Accounting clearly demonstrates - does not make money for a business because both making and storing goods cost money and tie up valuable cash flow.

If you would like to learn more about Throughput Accounting, why not consider our 1-day Throughput Accounting workshop? See our website for more details.

I & J Munn Ltd
22, Digby Drive
Melton Mowbray
Leicestershire
LE13 0RQ

Tel: 01664 502860

www.constraintmanagement.co.uk
www.toc-lean.com

If you would like further information or wish to arrange a course at a time to suit you and your organisation, please contact us by telephone or email:

Ted Hutchin
tedh@constraintmanagement.co.uk

Diane Jeary
dianej@constraintmanagement.co.uk