# Innovation Accounting: Necessity of Every Lean Startup


*The importance of traditional accounting is intuitive to be considered in a business project. It goes about measuring economic outcomes to make decisions by changing its course and speed. For well established companies, there exist standard measures of progress. Irrespective of type of business, a company's financial statements come handy to measure the health of a business. But in case of early startups or products, the financial statements are not as useful. At the start of an innovation project, there exist no economic results and if at all they exist, the only relevant information they provide is that they are losing money every month. The characteristic of startup is that it develops in a context of high uncertainty where there is hardly any history and certainty. Only hypotheses exist and predictions are almost impossible to be made. But still, every start up needs to measure where they stand and how they are evolving, so that early decisions can be made and corrective actions can be taken. In this context, traditional accounting hardly provides any support with valuable information to understand if start up is doing well or not. Hence, there is a burning need of a new kind of accounting for early stage products. The answer lies in 'Innovation Accounting.'*

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## Introduction

The world is headed by innovations. New products and services hit the market almost every day, hungry for its space in the customer's mind. Entrepreneurs have new, crazy ideas for the world. Startups like Facebook, Snapdeal.com, Bigbasket.com, Twitter and many such more are smart enough to woo investors as well as customers. But the BIG QUESTION is: **"are traditional accounting techniques equipped enough to harness the growth of these startups and innovations"?** And the answer is NO, since traditional accounting works best when measuring established products or on-going concerns.

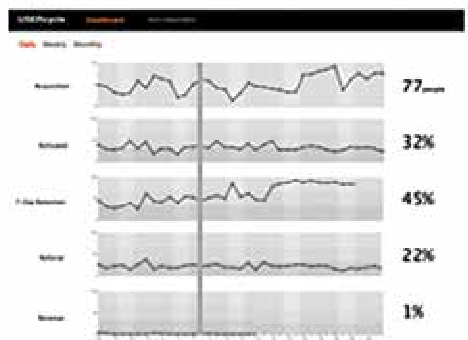
By definition, new innovations have a limited operating history and little to no revenue. In addition, they are burning cash well in excess of revenue. Hence, financial ratio analysis, cash flow analysis and other standard practices shed an unflattering light on new innovations, especially in comparison to existing products or business within established companies. Hence, a new accounting practice becomes the need of the hour.

the true progress of innovations such as customer retention and usage pattern.

## The Need

'How do you know you are learning?' - that's the question that haunts most of the entrepreneurs- not just to measure his/her own progress, but to continually justify the existence of ventures to investors (for startups) and to management (for established companies). The people who invest money, time and resources into one's idea are probably aware of the fact that they have to wait for a long time to see a return on their investment. But, it's their right to know if things are moving in the right direction. *Innovation Accounting* is the answer to all these questions and issues.

Financial accounting




Innovation Accounting

Rather than relying on revenues alone, innovation accounting defines a set of macro metrics that can be used to model the customer life cycle. Revenue happens to be one of those macro events, but not the only one. Macro-metrics are the powerful tools that provide leading indicators to revenue even before its realisation. To be more specific, one can actually define and measure customer value before some of this value is captured back i.e. it gets paid. Thus, innovation accounting is the rigorous process of defining, empirically measuring and communicating

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## Definition

Innovation Accounting is the term Eric Ries described in his book 'The lean start-up'. He defines innovation accounting as follows:

*"It is the system or process that allows the decision makers of the business to prove objectively that the developments that are making to their product are having a measurable impact on the behavior of their customers."*

Thus, innovation accounting is a measurement/ accounting system that uses actionable metrics to evaluate how fast one is learning as a critical measure of progress towards converging on a business valuable result.

## Holding Innovation Accountable

There is more to innovation accounting than just the ability to define and measure progress. And that *more* is to hold *innovation accountable.*

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Very much like financial statement can be used to hold companies accountable, innovation metrics can be used to hold entrepreneurs accountable which is good for both external stakeholders and entrepreneurs.

1. Innovation accounting can be used by external stakeholders to continuously and systematically de-risk their investment in smaller batches versus employing the traditional "all-in" approach.
2. Innovation accounting can be used by entrepreneurs to get fast feedback loop that both informs about most critical business model assumptions and this in turn provides them an opportunity to course correct before it is too late.

## How Innovation Accounting Works (Metrics Development)

According to *Ries*, innovation accounting works in three basic steps:

1) It uses a minimal viable product (MVP) to establish real data on where the company stands at any given juncture. An MVP is the fastest way to establish a customer feedback loop with minimal output of effort, *Ries* says. Its primary goal is to test fundamental business hypotheses without having to perfect the product or service in question too prematurely.
2) Using the MVP, start-ups, through many attempts, move from the baseline to the ideal, when the company then reaches a decision point.
3) At this juncture, a company is either making solid progress towards the ideal enough that it makes sense to continue, or persevere. If not, the strategy must be deemed flawed and in need of serious change—or as Ries labels it, a pivot, which starts the process all over again and in a more productive fashion than before.

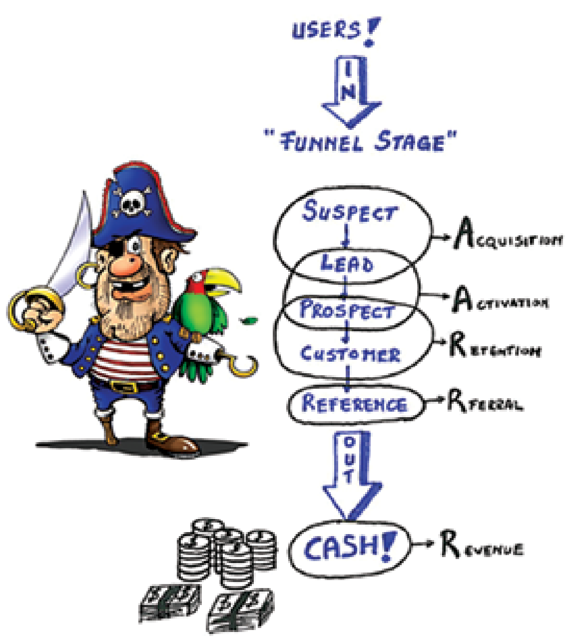
Innovation accounting represents the entire set of metrics and indicators that are used to make data based decisions, long before having an impact on the economic accounts.

It is not about having an infinite collection of indicators, but having the essential minimum that provides value to make good decisions. A good indicator must be:

1. **Controllable:** it should lead to a clear cause-and-effect relationship, so that one can infer the causes of variations to learn from them and make decisions to correct/improve it.
2. **Accessible:** it must be easy to obtain and understand.
3. **Auditable:** they are credible and be tested without much complexity.

The three major families of indicators that are widely used are:

1. **Metrics related to learning process:** As suggested by Eric Ries, validated learning is the progress unit of the startup, and it can be modeled and measured. It helps to make decisions regarding the validation state of the hypotheses and assess the quantity and quality of work done by the promoter's team.
2. **Funnel of conversion and cohort analysis:** These funnels make a lot of sense at the moment of selling of products/services. These techniques allow analysing the behaviour of each group of customers through the sales process. Use of percentage rather than absolute amount allows one to compare and see evolution in time, regardless of the total number of customers.
3. **Growth engines:** Similar to funnels, these make sense at the moment of the sales process and it becomes further important at the stage of growth.



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### Example

AARRR Framework: AARRR (double A triple R) is a wonderful framework to help better understand the consumers. It helps to measure the funnel and enables to optimise it for the better. It is a perfect tool to make more informed and data driven decisions.

The AARRR framework is divided into five basic steps:

1. **A-Acquisition:** How much time and efforts are required to acquire a new customer?
2. **A-Activation:** How much time, effort and convincing ability is required to activate the acquired user?
3. **R-Retention:** Is my product addictive enough to bring back the same customer again and again?
4. **R-Revenue:** Is the retained customer ready to conduct monetisation behaviour?
5. **R-Referral:** Has the customer found the product worthy of referring to others?


### Conclusion

Innovation accounting is an exciting discipline that forms a key and simple control panel for the governance of an innovation project. In simple terms, innovation accounting is just a way to stop wastage on developing big expensive features for the product that ultimately won't make any difference to the customers and are therefore effectively waste. The whole reason the movement is called 'lean' is that it tries hard to eliminate waste. Innovation is such a murky and misunderstood area in business these days, that by creating some systems of measurement around how to innovate and what to innovate on, then hopefully, business will be less wasteful. ■