Lean Accounting VS Financial Management: Awareness and Overview

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Abstract:
For the past decades, financial folks relied on old principles, techniques and theories in
determining the performance of the companies and give feed backs to the executives and CEOs
so they can make the necessary improvement and take decisions. The CEO wants help finding
the resources to fund a new project; he wants to know where we can improve costs in products
and services, and he wants to know whether improvements made have resulted in financial gain.
The CEO needs help seeing where the company has improved or declined and what the future
looks like given the current circumstances.

Unfortunately, many corporate management accounting systems are inadequate for today's
environment. They haven't been improved substantially since then. A famous example of this is
the use of ABC (Activity Based Cost) system. Jean E. Cunningham and Orest J. Fiume indicated
that many companies have found ABC encourages batch processing in order to spread costs over
a larger number of units in favor of reducing the unit/cost.

In the unique book Real Numbers by Jean E. Cunningham and Orest J. Fiume, the authors
presented how for decades US was the world's manufacturing giant, home of quality and
efficiency. Many industrialists didn't notice until too late that they were getting clobbered in the
marketplace. Especially in the automotive industry, giants like GM, Ford, and Chrysler were
losing significant market share to Japanese companies, led by Toyota.

Because most of accounting systems were mostly developed in the early 1900s to support
manufacturing products in batches, these same systems now send wrong, and sometimes
disastrous signals in a lean environment. It is like an island in the stream, the accounting areas
have remained rooted to the methods that have been taught in business schools for decades.

If you work in an accounting department, look at where your department is and where people
go during the day. Do accountants come in, sit at their desk and remain fixed there all day long?
Are they far from the rest of the action? Do they ever go to the site where parts are being
purchased, where products are being designed? If they do not, if people from through the
business have to come to accounting to seek information, it is a good indication that the
accounting team is sidelined!

Current financial models
Companies that are moving rapidly to lean and seeking to continuously improve their processes
will find that the current financial model is not working because most of financial models are
based on large batches which is against lean production. Lean is based on making to order
(Soliman, 2015).

A classic example is the use of EOQ & EPQ formulas
The terms Economic Order Quantity & Economic Production Quantity have been around for
many years much longer than lean methodology and Just in Time. EOQ was first developed by
F. W. Harris in 1915. The problem is that EOQ is an old term from the old days getting used in a
new world in a new way. It doesn't take into account many of the hidden losses. The major
problem with EOQ is that the model is viewed as static. Using Lean, the model changes with every improvement.

Unfortunately, EOQ is still being taught in many international business, financial, and cost management programs in the universities and in all over the world without considering the dramatic change made by lean and the transformation to the material movement methods. Making Materials Flow by LEI provide the necessary material calculations for the lean environment (Harris, 2003).

The most common problems that can be found in the current industrial accounting & cost accounting processes that need to be adequate are summarized here:

1. **Financial thinking is still stuck on batch production**
   One clear example for this is keeping a piece of equipment running constantly utilized because accountant said this machine must run constantly to make it profitable and keep unit cost low. So company's buy materials it doesn't need, pay an operator to run parts that are not needed and puts unnecessary tear and wear on the machine. This is all done because accounting blessed the machine's purchase based on specific parameters, which included sales projections which were too optimistic (Ahmed, 2014).

   In lean, if you don't need the parts, don't run the machine. The cost of resources spend to make unsellable products plus the cost of holding the inventory is greatly bigger than the cost of not utilizing the machines to their maximum capacity (Ahmed, 2014; Soliman, 2017).

2. **Financial data arrives late and often misleading**
   When accountant deliver old news, what do we do with old news? Accountant in many instances spend a lot of time counting things and producing outdated reports while many of these costs can be easily expected and placed before the end of the month. If you want the information to be valued, don't give it to the executives after the activity is completed! In some cases, information is weeks late. In lean environment, immediate visual feedback is required in order to eliminate root causes and prevent problems from recurring to gain high competitive advantage with your business operations.

3. **Matching**
   All costs to manufacture the goods you sell must be recognized as an expense in the month you recognize the revenue. Most costs need to be recognized in the month they happen. A practical example: the materials that you bought for a product that will ship in two months will be kept as inventory on your balance sheet. It is not an expense until you ship the product. The cost of advertising that product, or any other, is recorded as an expense on the books in the month it happens. This has been the genesis of a lot of standard cost accounting techniques. In lean, as lead time shrinks, products that are being made should be shipped in the same month so there is an opportunity to simplify accounting procedures and produce meaningful reports.

4. **Moving rapidly to automation**
   In many companies I have seen, switching to automation became a source of cost reduction. In many instances, this can be just a form of transferring the costs from one area to another (from
Direct to Overhead). Moving to automation without eliminating wastes is just like automating the wastes.

Taking the example of complex and expensive machines/lines that can combine several processes in one process, usually the cycle time of those machine slower than the cycle time of the other simple machines (cycle time is the time required to process one unit of product). Often those complex machines are not flexible in responding to the high increase in demand so you have to buy more expensive machines to expand your capacity if the demand was to increase.

At the other hand, if demand is decreased you are stuck with non-utilized expensive machines and this involve a high depreciation cost that you will have to pay independent of the production volume.

With the simple machines, they tend to cycle faster and usually perform fewer types of tasks/processes or only one process. They are better anyway in term of demand fluctuation. They can respond to demand increase or decrease more efficient and at lower costs.

Accountant also spend a lot of time trying to collect costs using bar codes and other modern methods. Without improving the process itself, using advanced technologies can became another source of money wasting.

5. Financial statements
When financial statements became difficult to understand they became not trustfully, because we don't trust what we don't understand. The reports must be presented in a manner that can be read and easily understood by non-accountants.

Unfortunately, some business programs have gone the route of teaching all people in a business how to understand the numbers. Companies create classes for their employees to help them understand the numbers. Would not it be easier to make the numbers understandable? Non-understandable reports, inefficient reports and late reports can be all classified as waste.

6. Performance reports
All companies attempt to establish metrics to determine if they are achieving their goals. Unfortunately, many of these measures are too complex for average worker to be actionable, and some create dysfunctional behavior.

Also there are many performance measures that you don't need or don't present the real state of the company. There are many other helpful measures that are available in the lean books and references which can be used to help executives make decisions.

Example, one of the business premier measures, stressed in most financial management programs and treated as one prevailing metric, is return on investment ROI. As currently practiced, ROI is an excellent example of the intent to capture many complex and interrelated events, thus creating one monster of a metric that few people can relate to their daily activities. ROI involve huge parameters and factors and should not be used as a standalone measurement and should not be used as the only measurement around. If everything is being counted in term of immediate or direct financial benefits, the indirect improvements to quality, down times and setups may not get the attention and the resources they deserve because everything is being evaluated in terms of financial benefit. Many direct financial metrics are not efficient in the modern environments and you have to develop your own ones and shift people's thinking so they can think more proactively in terms of company's success and customer. Liker (2003) quoted
“Base Your Management Decisions on a Long-Term Philosophy, Even at the Expense of Short-Term Financial Goals.”

7. Stuck with cost accounting rather than cost management
It is far less important to count the cost of making a product that it is to manage the cost of the whole business. Traditional cost accountant is dependent on establishing a standard method for calculating the cost of making every product and every component the company make. In most of companies, the accountant department is trying to figure out the best method of calculating costs rather than trying to manage, reduce and plan the cost of designing and making this product.

Most studies show that 80-95% of the life-cycle cost of a product is committed during the design process. That mean only 15-5% of the total cost is susceptible to future cost reduction effort without redesigning the product.

8. Budget planning
Every year we see financial guys negotiating for a tough budget and operations guys negotiating for an easy budget so they can look good. In the end, the financial guys own the budget. Operations can say "It is not my fault you gave me a bad budget" Often this creates a lot of conflicts between operations and accounting. Financial guys always wait until the end to provide an evaluation and judge the situation, then report what went wrong. Would not be better for them to begin with the planning process and offer help? Chief Financial Officer, Greg Flint quoted “I don’t think budgets are worth a hill of beans. They are based on guess work and politics.”

9. Accounting process and non-value adding activities
Many accountants spend time doing non-value added activities, record unnecessary information, produce unneeded data and duplicate things. Even the value added work they do may arrive late (the reports) so it became obsolete and outdated. There is no systematic method to produce on time reports to help track the root causes of issues. What have gone wrong have gone wrong, what is the purpose from keep recording it??!

   I personally found many accounting systems contain waste. As with any other business process, accounting processes can be improved to eliminate waste and allow for more timely reporting of valuable information (lean accounting).

What should we do?
Sometimes improvement has been blocked due to barriers created by accounting. If managers didn't notice the effect of improvement on the company's performance, they won't support the idea or commit to the resources required. How many times have we heard executives say, "What you really do has no benefit to the organization? I don't know what you are doing, but whatever it is, stop it, you are killing profits."

   Involve your account people in the change. If they are not involved in change, the will remain mired in the old culture, along with batch processing and standard cost accounting. Accountants are not just a report generator, they are business partners.
Accountants should switch themselves from focusing on transaction processing or bean counting to becoming valued business partners who contribute meaningful information for decision-making purposes.

**The goal of accounting education**
The goal of an accounting education is not to prepare for a life time recording debits and credits, but to learn a language and tools to assist a business toward better performance.

As you continuously improve your process and make serious progress in the transition to lean manufacturing, you have to continuously improve the accounting method, keep accountant folks updated, educate them and get them involved in every step you make. This is to avoid the serious disconnect that will occur between the operations and accounting (Byrne, 2012).

**What happened to cost management certification programs?**
I personally hold a certification in cost management that is internationally accredited. And I'm pretty confident to say that it only served as start so you can begin thinking on how to improve the way things are being done in your organization. It didn't provide information on how lean accounting work or how to improve costs, just a background on how basically cost is being counted and planned so you can brainstorm where the defects are coming from. I got the knowledge through practicing lean and reading a lot of lean and continuous improvement references.

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