Lean Accounting

By
John L. Daly & Dan Chenoweth
Executive Education, Inc.

Lean Thinking

Lean thinking is not new. Business people have always known that efficient organizations can serve their customers better and make more money. However, the term "Lean" is just over 20 years old. In 1988, a graduate student at MIT first coined the term in an article describing the Toyota Production System (TPS) [1]. While initial research into lean involved lean *manufacturing*, people studying these techniques quickly realized they could also apply lean *thinking* to all other business activities including running an accounting department.

The term ***lean accounting*** has two distinctly different uses. One usage means to use lean techniques to manage an accounting department. However, many people have also used the term "lean accounting" to describe accounting for lean operations. Like many lean practitioners, we chose to distinguish the two uses by referring to the second usage as ***accounting for lean***. This article will concentrate on the process of financial statement preparation in a discussion of lean thinking as it applies to accounting department operations.

Lean thinking involves five concepts:

1. Defining Value.
2. Identifying the Value Stream.

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[1] John Krafcik, ***Triumph of the Lean Production System***, the Sloan Management Review, 1988.

3. Making the Value Stream Flow.
4. Implementing a Pull System.
5. Striving for Perfection.

Defining Value

How do financial statements provide value? To understand this question, financial professionals need to engage in dialog with statement users. Many company controllers have never done this. Sitting down and discussing financial statement content and format with department managers, company officers, your banker and board of directors is a useful exercise.

Issues for discussion should include:

- Are the statements at the right level of detail?
- Is data collection at the right level of detail?
- What additional information would be useful to financial statement users?
- What are users getting that they do not need?
- What non-financial measurements of business activity should accompany the financial information?
- What metrics, such as revenue/unit, cost/unit and gross margin/unit, would help users better understand the financial information?
- What non-financial metrics drive financial performance?
- How do non-financial metrics, such as investment in people, operating efficiency and quality, fit into a balanced understanding of financial performance?

Understanding value from the user's perspective will often tell you that accounting is going to considerable extra effort to prepare information at an unnecessary level of detail. Some innovative accounting departments create "service level agreements" with their internal customers. These agreements describe what information the internal customer wants to receive, the level of detail the information will represent and when they will receive it. Quarterly, follow-up meetings provide a vehicle for discussing the accounting department's performance against the original agreement and identify necessary changes going forward.

It is rarely a good thing when financial information is detailed and complex. There is a wonderful elegance in making financial information simple to understand.

Identify the Value Streams

The term ***value stream*** means the process that provides value to the customer. Thus, once we know what financial statements users want, the next step is to analyze the process used to create the information. In this step, lean practitioners attempt to identify those activities that provide value and not provide value to the customer.

If you diagram a typical accounting process, you will find a significant amount of effort involves making certain that information is correct. For example, significant portions of most company's month-end closing processes involve error detection and correction. How does reconciling your accounts receivable or payables aging to the general ledger add value to the financial statement user?

When we look at account reconciliations from this perspective, we realize that errors take value away from financial information. Reconciliations only put back value that errors took away. In the absence of errors, account reconciliations create no value at all! If we could eliminate the errors, we could eliminate the reconciliation.

Ten to twenty percent of company controllers attending Executive Education's seminars report that their accounts receivables and payables reconciliations never or almost never have errors. They have "airtight" business processes that prevent the transactions in these accounts from ever being different from the general ledger. Even though these companies still reconcile their AR & AP aging, the work takes only seconds because the balances always reconcile.

Identifying the value-added and non-value-added steps in an accounting process gives you the ability to eliminate or reduce the non-value-added steps. You can manage this process more easily in the context of continuous improvement than as a big project designed to solve all of your problems at once. Big projects can overwhelm your people resources. However, the improvements from one small project can easily provide the time to do another small project.

Make the Value Stream Flow

A key objective of lean thinking is to make value flow quickly and freely. Few accounting departments attempt to make information available quickly and on demand. Most accounting departments process financial information in huge chunks representing a week or a month's worth of data. Is the liability for the goods your company received yesterday already in your accounting system? Can your CEO see a financial statement this morning that is up-to-date through last night? In most companies, the answer is "Sorry! We don't operate that way!"

However, some organizations are able to produce a useful year-to-date financial statement at any time. These statements do not follow completely generally accepted accounting principles at mid-month. Every organization has certain expenses they only recognize once a month. However, the statements reflect everything that occurred almost up to the hour. This usually includes all sales, cost of sales and the value of goods received. These companies also have accurate balance sheet valuation of cash, accounts receivable, inventory, accounts payable and, potentially, most other accounts. While the information is not GAAP-perfect, it is highly useful because it is up to date.

There is an old saying in inventory management that says:

> *"If you want to see the rocks, lower the level of water in the river."*

This means that if you want to see where the problems are in your systems, start removing the cushions that you have built in. Perhaps you completed month end financial statements in seven days last month. What is preventing you from doing it in six days, in five, or in four?

To be able to do things faster in your accounting department, you are going to have to find ways to do them better. Error elimination is a major cost cutting opportunity in most accounting departments.

Implement a Pull System

Can the users of your financial statements access them at any time? Can they access month-to-date information at any time? Unfortunately, this is not possible in many organizations. One core reason is that accountants often create financial statements in MS Excel rather than using the general ledger report-writer. When we create reports in Excel, someone has to download general ledger information and manipulate it, preventing on demand availability of the information.

Implementing a "pull" system for financial information is a major advance in sophistication for most organizations. Most accounting departments "push" financial information to users when accounting is ready to distribute it. Only well-tuned financial systems are capable of allowing users to pull financial information at any time.

Strive for Perfection

Does your accounting department make continuous improvement a normal part of its routine operations? Is everyone in the department working on projects to make the company better?

One effective way to improve continuously is to meet with each person who works for you once a quarter to develop a plan for the next three months. Each person should consider the quarterly plan a commitment, not an aspiration. Thus, 80% of the time a person should have completed all of their projects by the end of the quarter. This meeting is very different from traditional performance reviews because the focus is on the future, not on the past. The meeting begins with the team member presenting a self-evaluation of their performance against the last quarter's plan. Writing this self-evaluation should be easy because each person should have completed every item on the plan. As they completed each point, they should have updated their boss and gotten a pat on the back.

Future planning should be the meeting's focus with each person bringing a draft of their plan to discuss with their supervisor. For managers, the plan may cover five projects they will accomplish. Plans for clerical people often include three projects plus standard measures of the quality and quantity of their output.

How do you assure that the quarterly meetings will happen? Some companies tie the quarterly meetings to their bonus program. Thus, there is strong motivation for the quarterly meeting to occur.

Conclusion

You can apply lean thinking to every area of the organization. A great book on this subject is ***The Toyota Way*** by Jeffery K. Liker. Even though you may not be in manufacturing, reading about how Toyota uses lean techniques throughout their organization will help you shake up your thinking about how to manage everything from product development to processing accounts receivable. Open your mind to improvements you can make. Continuously getting better will keep you on the leading edge of our profession.

JOHN L. DALY, MBA, CPA, CMA, CPIM, is a Chelsea, Michigan based management consultant specializing in pricing, costing and business turnarounds. Earlier in his career, John was Chief Financial Officer for a medium-sized Tier 1 automotive parts supplier. He has also been CFO for a large restaurant chain and COO for a manufacturer of window treatments. He began his career with five years working for the management consulting divisions of two large public accounting firms. John is the author of ***Pricing for Profitability*** published by Wiley & Sons and co-author of Executive Education's one-day ***Lean Accounting*** seminar. Forty North American associations present Executive Education's seminars.

DAN CHENOWETH, MBA, helps clients take their strategy to the bottom line through rigorous project management and change management techniques, and by engaging and motivating their people. With over 25 years of experience, he has held executive level positions in general management and finance in a number of industries including telecommunications, printing and publishing, heavy equipment manufacturing, and apparel manufacturing. Dan lives in Loveland, Colorado.