

## The Obstacle to Lean Accounting

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The big problem with lean accounting is that, for the most part, we are incapable of dealing with reality - and I don't mean accounting's inability, I mean the rest of management. I have discussed lean accounting with literally hundreds of accountants, and I have yet to meet one who says that standard costs - or any version of full costs with all of the overheads allocated or assigned, whether it was done via traditional methods, activity based methods, or anything else - are accurate. Accuracy and integrity are accounting's stock in trade. The South American coffee industry thrives because of it. These people will work all day and night to resolve a few pennies of discrepancy in a million dollar balance sheet.

They know the full cost they generate is not a true statement of the cost of something. But they also know that their customers - the people who set prices, make planning and capital investment decisions, and those responsible for make-buy decisions - are far too often incapable of sorting through and making good business sense of the complicated realities. Full costs are not accurate, but they make life simple. Accountants often believe that full costs, while not true, are directionally good enough and that decisions made with them will generally be better than the decisions made by people with true, but messy, data that lean accounting provides. In many companies they are probably right, but that does not mean that lean accounting is not an improvement. It only means that management has a problem to solve.

The gross error in full/standard costs is fairly obvious. For one, the assumptions built into them concerning fixed versus variability wreaks havoc on just about every decision. All costs are fixed in the very short term. All costs are variable in the long term. Standard costs treat them as if everything is variable, regardless of the time frame, ignoring the degree of capacity utilization the fixed costs can support. Lean accounting peels all of those fixed costs away and states them as they are, leaving little in the variable cost bucket to be assigned to individual products.

Worse is that all costs have multiple drivers, and many - maybe most - are not a function of any particular product. The maintenance cost of a machine is a function of hundreds of variables, ranging from the number of hours the machine is used, to the effectiveness of the design and execution of the preventive maintenance process, to the viscosity of the lubricants used and the ambient temperature of the room in which the machine is located. To select one cost driver - labor hours or machine hours, for example - makes it simple to allocate maintenance costs to each product, but it is not remotely close to the truth. Compounding the inaccuracy is that most factories have more than one machine that can perform any given function, and it is typically a rather arbitrary decision to assign a product to one machine, with one cost rate, instead of to another machine with a different rate.

The fallacy of full costing would take a book to document - and such books have been written. This is generally not in dispute. The issue is the challenge of managing with reality, which is messy.

Life is actually pretty easy for folks in sales and marketing who are typically involved in pricing. The full cost provides them with one number per product, and call it what they may, they engage in what boils down to a fairly simple cost plus exercise and determine a price. If that price is too high to land the sale, they can blame it all on the cost. They really do not have to know much about the costs, and while many of them have become quite proficient at gaming the system -

lobbying eloquently to have their product arbitrarily run on a different machine or a different cost center, for instance - they do not need to know much about what is really behind those costs.

It should come as no surprise. The only real exposure to accounting many of them have had was back in their college days, and many sales and marketing folks being the social animals that make them good in their chosen field, followed the same guiding principle in college that I did - that 'a C gets a degree'. If they paid attention to Managerial Accounting 101 at all, it was likely full absorption standard costing any way, and since embarking on their marketing career they have had no reason to explore the subject any further.

Now along comes the Lean Accounting expert, telling the accounting department that they should quit cranking out standard costs, and give the sales and marketing folks "Real Numbers". Specifically, they should be told that product profitability is a myth - that no product is profitable, only businesses are profitable; that the actual product cost is a very small number consisting only of the direct material it takes to make the product; that pricing is a strategic endeavor. The sales and marketing guy is given a hundred or more of these minimal product costs, a statement of the fixed value stream costs that pricing for all of those products has to collectively cover, is thrown into a room with some operating people to get a feel for what the capacity utilization levels are in the value stream, and told to come up with collective strategic pricing that maximizes utilization of the value stream resources and cost base, and assures long term success with the customers relative to the competition. And, of course, makes the company profitable.

The sales and marketing people break out into a cold sweat - this is complicated, analytical stuff that requires decision making in the face of uncertainty, and puts a lot of responsibility for the results of the business on their shoulders they have never faced before. It expects them to have a solid grasp on how all of these costs behave, and to understand capacity issues they have always been able to ignore. In the past they have been able to focus 100% on sales and marketing matters well within their comfort zones, and blame accounting and operations for everything outside of that zone. Their input to cost issues has been limited to consistently sending a loud message that if only they could price everything lower they would be able to sell infinite quantities of everything.

What I hear from accountants almost all of the time is very well founded fear at what will happen when these financial neophytes who have a history of seeing low prices as the universal key to success are thrown into the wide open world of lean accounting and given the authority to make 'strategic' decisions. Full costing is wrong - very wrong - but it has one thing going for it that lean accounting doesn't - it is safe. It protects the company from the generally low level of financial capability its management possesses.

I have picked on sales and marketing but the problem really pervades just about every corner of most organizations. It is the product of a hundred years of functional management and functional thinking. Ops people stayed in Ops, marketing people stayed in marketing, accounting people stayed in accounting, and no one needed to - or was even allowed - to stick their nose in the other guy's tent. Lean accounting is a process of managing the business with accurate, comprehensive information, and it makes much, much better decision making possible, but it requires skills and capabilities that are beyond the reach of many manufacturers. Operations and engineering are responsible for what goes into the standard costs, and sales and marketing worries about what comes out of them - and accounting with the standard cost system is both the buffer between them, and the glue that holds it together. Then along comes lean accounting, knocking down the buffers, throwing raw data on the table, and saying, "Everybody work together and sort it out in a comprehensive manner for the good of the whole." That is unnerving for everyone involved.

The answer to the problem is to develop the skills of management - not to reject lean accounting and continue to rely on terribly wrong and misleading accounting information simply because it is safe. The appropriate response from accounting is not to reject lean accounting in order to protect the organization from itself. Rather, it is to embark on a serious training and education mission - to accept it as accounting's responsibility to raise the level of financial management knowledge and thinking to the point at which the inherently superior information from lean accounting can become the engine for superior management decision making.