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**Special Edition – Report on 2006 Lean Accounting Summit**

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Dear Executive:

Through the courtesy of the Institute of Management Accountants and SAS Institute, I was able to attend the 2006 Lean Accounting Summit in Orlando from September 20<sup>th</sup>-22<sup>nd</sup>. As many of you are aware, “Lean Accounting” has become a hot button issue in the management accounting community. The Institute has recently issued two new SMAs (Statements of Management Accounting) on the topic of “lean” – “*Lean Enterprise Fundamentals*” and “*Accounting for the Lean Enterprise: Major Changes to the Accounting Paradigm.*” A third SMA entitled “*Applying Lean Accounting Fundamentals Beyond the Manufacturing Floor*” is in production and will be issued soon. The IMA has also included several sessions on topics related to lean accounting on the program for its 2007 Annual Conference.

It should be noted at the outset that “Lean Accounting” is a phrase used to mean two totally different things; accounting for the lean enterprise and having a lean accounting function. With two definitions of the same phrase it is often difficult to “avoid obfuscation” when discussing the subject. To avoid as much confusion (and obfuscation) as possible, lean accounting will be defined as accounting for the lean enterprise in this letter except where otherwise noted. Further complicating the discussion has been the evolution of the concept of value-stream accounting (or value-stream costing) as the “official” manifestation of lean accounting. Since the topic of value-stream accounting or costing will appear many times in this letter (and I don’t want to misrepresent its tenets in any way) you may want to familiarize yourself with the concept by visiting the BMA, Inc. website at [www.maskell.com](http://www.maskell.com).

With these preliminary comments completed, let’s move on to my report on the 2006 Lean Accounting Summit....

General Observations and Comments

From the sessions I attended, the subject matter of those sessions I did not attend, and comments from other attendees I spoke with during the conference, I would estimate that less than one-third of the sessions had anything to do with *accounting for the lean enterprise*. A few had to do with *applying lean concepts to the accounting function* and the balance related either to *lean concepts generally* or didn’t have much to do with lean at all (like Target Costing and Using Rolling Forecasts). The title of the conference as a “Lean Accounting Summit” was somewhat misleading.

Most of those who presented the non-accounting related sessions did not seem to be all that familiar with the tenets of value-stream accounting. They believed that standard costing (a

term they incorrectly used to include any absorption costing for financial accounting purposes) was obsolete and dysfunctional for supporting day-to-day management decisions (oh boy, what a revelation!) and needed to be replaced. Since the word “lean” was used as an adjective before the noun “accounting,” they seemed to assume that something called “lean accounting” must be a lot better. As you’ll see from their comments included later in this letter, many of them either stated directly or indirectly that absorption-based process and product costs are still required for certain types of decisions or to highlight areas where lean actions would yield the greatest return – ideas seemingly at variance with value-stream accounting.

My very small, unscientific sample of attendee opinion gathered at breakfast, lunch, breaks, the airport bus stop (and on the bus), etc. showed very few who were accepting the value-stream concept “hook, line, and sinker.” Most had an uncomfortable feeling about value-stream concepts but their lack of experience in the area made it difficult for them to isolate the specifics that gave them that feeling. However, since value-stream accounting requires a significant paradigm shift, such uncertainty is probably to be expected from anyone.

### Thought Leaders Meeting

I sat with Jeff Thomson of the IMA during the half-day “thought leaders” session which, like the conference itself, was really misnamed. It appeared to be a “concept promotion strategy” session with no intention to discussing “lean accounting” or “value-stream costing” itself. Jeff and I did jump in early in the session and did our best to be the “not-so-loyal opposition” and promote a discussion of value-stream costing itself. We pointed out that an ABC model at an established lean organization looks a lot like value-stream costing, but value-stream costing does not reflect the economic realities of an organization that is not already very lean. As a result, it would not highlight areas for improvement, nor would it provide any other insights for managing the organization effectively.

I also tried out a statement that I “lifted” from Joe and Catherine Stenzel to get a reaction from the group. That statement basically defines “lean accounting” as “ways that established lean enterprises treat accounting and performance measurement” (the underline is mine). So I suggested that value-stream costing might be appropriate for “established” lean organizations, not for organizations on the journey to lean but still far away from the destination. Although the statement got some “ah, yes” nods from some of the participants, it solicited a rather strong and dismissive negative reaction from the others. “Of course, it was for everyone...you just use non-financial measures to direct and encourage lean behaviors.”

It was interesting that during the session the participant from Toyota (aka “the holy grail of lean”) made a comment that can be paraphrased as follows; “Of course, we have learned about concepts such as ABC and use them at our plants where we think it is appropriate.”

Most of our comments were dismissed without any direct counter argument. It was interesting, however, when Robin Cooper made his appearance during the second half on the session. He was, of course, totally unaware of the discussion (or lack thereof) that went on earlier. Almost as soon as he arrived he made the statement, “*of course, ABC principles stand in the middle of lean accounting.*” Although Jeff and I quietly nodded to each other, the others in the group pretended they didn’t hear what he said and carried on with their conversations.

## Conference Sessions

Presenters at most of the sessions I attended contradicted the value-stream accounting argument that product and individual process costs are never necessary. I don't know if attendees caught all of the contradictions (obviously I was looking for them), but they were many. For example:

- Jim Womack (founder and president of the Lean Enterprise Institute) basically ignored the topic of lean accounting altogether in his keynote address
- Jamie Flinchbaugh (founder and partner of Novi, Michigan's Lean Learning Center and my favorite "lean luminary") emphasized the need to understand how things currently are – to "build visibility into your processes" – before moving forward with lean actions. Value-stream costing makes process costs invisible. Jamie also had many other "gems" like:
  - "Lean is not born from what we SEE. Lean is born from how we THINK"
  - "Accounting is already too much about tools – and lean is making it more so. Lean accounting should be about more than tools, but principles that drive us forward to the ideal state."
  - "The raw material of management includes insights into choosing a useful vision and understanding of cause and effect..."
  - "The first responsibility of a leader is to define current reality."
  - "The path to understanding includes...build visibility into your processes; develop the lens and language for observation..."
- Richard Schonberger (originator of the term and concept of world-class manufacturing) emphasized that cost data was required for "infrequent decisions" – his examples included pricing, outsourcing, drop/add – and further stated that cost information should be the output of "periodic ABC analyses."
- Jim Swartz (author of the bestselling management book *The Hunter and the Hunted*) constantly made the point that one needs to find "high-level, high-reward" opportunities to apply lean – a statement that presupposes the ability to measure the economics of a lean opportunity – and that most companies pursue too many "low-level, low-reward" opportunities. He emphasized the need to "identify and quantify" (underline mine). A couple of his "gems" were:
  - "Target product line or delivery systems that are the highest dollar, highest growth, highest losers, highest profit, or most important to the future of the enterprise."
  - "If you see it it's probably low-leverage. You should focus on non-obvious, high-level 'found' opportunities."
- Robin Cooper (one of the most active and visible leaders in the management accounting revolution since the early 1980s) and gave a session on target costing in which he regularly highlighted the need to know how to bring a product's actual cost in line with its target cost – a difficult task if you cannot measure a product's cost.

## The Toyota Lean Economic Model Session

Bill Waddell's session (Bill is president and founder of Best Manufacturing Practices) on the Toyota Lean Economic Model proved to be insightful and, based on their questions and comments during his session, it appears many participants "caught on." Bill is a proponent of value-stream costing and kept emphasizing how Toyota doesn't need or use product cost information.

He then showed us how Toyota keeps its growth on a slow, linear growth path – with no sudden fluctuations up or down – by using its sales prices to keep demand at its current capacity. He explained how it does not worry about its profits during downturns, but instead tries to keep its plants at their capacity. On the other hand, it doesn't try to produce more than capacity when the market is up, but instead raises prices to keep its plants at their capacity. He continued by explaining how Toyota considers its labor force a fixed cost and does not add employees to chase opportunities in a good market or lay them off in a bad market.

He then explained how critical it is to keep demand on a slow, linear slope and treat your labor force as "fixed" to reach lean nirvana. Only by having such predictable demand and such a high percentage of fixed costs is it possible to leverage "leanness" into financial success.

Of course, the participants began pointing out their company's inability to manage their demand by playing with the price of their products, the natural "lumpiness" of industries such as airplane manufacturers, auto industry suppliers, and defense contractors, the impossibility of holding on to workers during downturns lasting quarters if not years, the use of "temps" instead of full-time employees during upturns, etc.

By the end of the session, he may have turned more folks "off" than "on" as a result of his dogmatic view of lean and the implication that we've all got to become like Toyota and that the rules must apply to all in the same way they apply to Toyota.

## Other

The value-stream accounting message attacks "standard costing" (like most folks in the arena it uses the term "standard costing" when it really means absorption accounting for financial accounting or traditional accounting) and implies that this makes all "allocation" techniques - including ABC/M - part of the problem. It then goes on to show that in a perfectly lean environment the method of value-stream costing is the perfect way to counteract this problem while reassigning (in lean you never lay off) most of your accounting department's personnel to other activities. It's the either/or argument that proponents of a singular point of view always use; namely, if you don't like Attila the Hun then you must switch to Karl Marx – there are no options in between.

Because of the quality of some of the speakers and the fact that lean thinking is a fundamentally sound idea, I believe many of the attendees went away with a fairly good impression of the conference and that impression might spill over to the value-stream costing argument by association - even though many of the attendees may not have attended a single session that discussed that topic. In other words, the concept gains credibility by association not necessarily by the strength of its argument.

The biggest things going for value-stream costing are 1) it is not absorption accounting for financial accounting and 2) it has associated itself with another movement whose proponents believe that using absorption accounting for performance measurement is a big problem. Value-stream costing may not be a very good answer, but it is an answer to problems perceived by day-to-day operating managers – problems that are caused by the traditional accounting methods and measures management accountants continue to blindly follow despite the fact that they have been proven to be inaccurate, irrelevant, misleading, and dysfunctional (other than that they’re not bad). The value-stream solution looks like it works to these individuals who spend their business lives touching “one part of the elephant” but it may not provide the accurate and relevant decision costing information needed by those whose task it is to manage “the entire elephant.”

In our quest to learn how we can best use management accounting information to help lead our organizations into a more profitable future, it is best to take Václav Havel’s advice and *associate ourselves with those who seek the truth and avoid those who have already found it*. Traditional costing practices are detrimental to a lean organization – there is no doubt about that – but the answer lies more in improving our knowledge about what costs are, how they behave, and how cost information drives management behavior than in a new costing system or methodology. As Jamie Flinchbaugh so accurately stated, *“Accounting is already too much about tools – and lean is making it more so. Lean accounting should be about...principles that drive us forward to the ideal state.”*

If you would like further thoughts regarding lean accounting, D. T. Hicks & Co. prepared a white paper entitled *“Cost Information and the Lean Enterprise”* back in 2004. You can obtain a copy of this white paper by simply e-mailing your request to me at [dohicks@aol.com](mailto:dohicks@aol.com).

I hope you all have a great holiday season and a healthy and prosperous new year. I’ll be back with the Winter 2007 executive letter in January when I plan on discussing ODD – Ostrich Decision Disorder. In the meantime, if you have any questions or would like further information, please do not hesitate to contact me. I’d be glad to discuss this or any other related subject with you.

Very truly yours,

*Doug*

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