Why Don’t the CFOs Support Kaizen®?

While speaking at the Machine Tool Industry Summit in Goa the other day, I was asked a question. The question went something like this, “Kaizen teams calculate and show financial benefits when they complete their projects. They look logically correct, but the benefits don’t seem to show up on the balance sheets. Where is the disconnect?” That was a brilliant question – obviously from a sufferer! I wish more people would come up with such questions, and challenge the Kaizen®/Lean community.

I gave a truncated answer due to constraints of time. It left me dissatisfied & I am sure it only provided a partial answer to the questioner. This is an extremely important question for all Kaizen®/Lean practicing organizations & as Kaizen®/Lean professionals it is our duty to try and provide a satisfactory answer.

Let us focus our attention on manufacturing & let us start from the beginning: Kaizen®/Lean is all about identification, step by step reduction & (eventually) elimination of muda from processes (or Value Streams). As we reduce muda's of motion, transportation, waiting, inventory, rework, over-processing & overproduction – we end up with some improvements, which typically result in the following benefits:

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Message from the Director

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Productivity is never an accident. It is always a result of a commitment to excellence, intelligent planning, and focused effort.

- Paul J. Meyer
1. Lower inventory
2. Higher manpower productivity
3. Lower space
4. Lower rejections
5. Lower Lead times

In a nutshell, for the same output we end up using reduced inputs. Hence, output remaining the same, we release some resources. Some released resources lead to a one-time benefit & others lead to recurring benefits.

One-time benefits occur in some cases. Examples:

- After Seiri, surplus material becomes available for sale
- Improved OEE eliminates the need to invest in a new equipment
- Released space eliminates the need to invest in some area of new land & building

The first example provides some cash in hand. Therefore, it is visible in the balance sheet as ‘other income’. The other two ‘prevent’ investments, but are invisible in the balance sheet!

Recurring benefits can be classified into three categories:

CATEGORY ONE -

CAPACITY (release of these resources will not show up in P&L until the released capacity is put to use productively)

1.1 Manpower: We always strongly recommend that manpower released from Kaizen® projects should never be let go/ laid off (that is suicidal since it would hit morale & kill Kaizen® straightaway). As the still manpower remains on the rolls, its’ cost remains within the balance sheet & does not show up in the P&L.

1.2 Space: Space is a costly resource. But empty space has no entry in the balance sheet & will not show up in P&L

1.3 Equipment: Often, during stabilization phase, we also end up improving OEE of equipment, because unstable equipment obstructs flow in a cellular layout or a line. Once again, machine capacity is freed up. While it is a tangible improvement, it will not show up anywhere in the P&L (This cost is a sunk cost, & appears in the balance sheet as ‘depreciation’. As we all know, depreciation does not change with better or worse utilization of equipment!)
Traditional accounting systems do not recognize how efficiently or how inefficiently these resources are used! That is a fact of life. However, common sense does tell us that none of the above resources are free!

**When will any benefit show up?**

**Answer** - Only when the freed up resources are utilized to produce & sell more products, the increased revenue will show up as a higher top-line & increased bottom-line! (Please refer to ‘IMPORTANT’ at the end of this write-up).

**CATEGORY TWO**

**INVENTORY** (Release of these resources will show up in P&L with a time-lag)

When inventory is reduced, in the first years of Lean implementation it shows up in the Balance Sheet as consumption & gets included in ‘Cost of Goods Sold’ (if they are sold, & not scrapped!). In traditional accounting system inventory is an ‘asset’ & the value of inventory held is used by banks as one of the inputs to determine an organization’s ‘credit limit’ for financing working capital. When the inventory gets reduced, banks threaten to reduce your ‘credit limit’.

That makes the CFO very unhappy.

If the CEO & CFO are on board with the Kaizen®/ Lean journey, they will know that reducing credit limit is not an unmitigated disaster, because that reduction will result in reducing ‘interest costs’ on the next balance sheet! But this years’ P&L shows no benefit at all! It only shows additional cost burden of the ‘Consultant’s Fees’!

Unfortunately, the CFO is mostly not on board. He finds this the second strong reason to become very unhappy! No wonder the CFO’s don’t support Kaizen®/ Lean!

The benefit will appear in P&L **ONLY WHEN** working capital loans from the bank are reduced (interest rates remaining the same!). However, sometimes these benefits get offset by some other invisible increases (that the Kaizen® teams are unaware of) –

- increase in interest rates or
- increase in accounts payables due to market conditions/ competition or
- inflation.

If this be the case, and the CFO has never been on board, we have an **anti-Kaizen® CFO for life**! Nothing you say or do will convince him otherwise!!
When will any benefit show up?

**Answer** – Only when the working capital bank loans are reduced. That can start happening, say 2 years after the kaizen® projects have been successful & have an adequate cumulative effect!

**CATEGORY THREE:**

**MATERIAL YIELD**: (This benefit shows up on P&L almost immediately)
Yield can improve by reducing material waste or reducing scrap generation. Such improvements reduce effective material consumption directly.

When will any benefit show up?

**Answer** – Immediately! In the very first P&L – but only if it is substantial enough! So, if we want friendly CFOs, we have two options:

- Keep them on board from inception of the Kaizen®/Lean journey
- Get substantial returns from projects of category three (which is not always practical!)

The good news is that Kaizen®/Lean practitioners have recognized these problems/infirmities globally. The entire body of knowledge covered by ‘Lean Accounting’ addresses these issues & has come up with simple, elegant solutions that will not let us go astray. It is strongly recommended that CFOs of practicing companies are exposed to these practices early in the Kaizen® journey. Help is available. In November 2013, a colleague of our friend Brian Maskell published a new book:

**The Lean CFO: Architect of the Lean Management System** by Nick Katco.

**IMPORTANT:**

Before I conclude, there are two secrets that the entire Kaizen®/Lean community should be aware of:

**ONE** – All of the above that we discussed, is based on the assumption that market demand is static. While that is true for some industries, we are operating in growing economies in India, Africa & Middle East. Released capacities can quickly be used to meet increased market demands in terms of volumes & variety of products. Financial returns from increased output (from the same resources) would be far in excess of pure savings accruing from Kaizen® projects!
TWO – Even if the demand is static in some cases, there are opportunities to in-source (reverse of out-source) some inputs currently bought out & try to use up the released capacity to leverage the calculated Kaizen®/ Lean benefits.

CONCLUSION: The objectives of Kaizen®/ Lean practices & the CFOs are aligned. We need to co-opt CFOs as natural partners in this journey.
VoV – Voice of VIP

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Mr. Shridhar has over 17 years of work experience with leading multinationals like Philips, ABB, Webex Communications (now CISCO), etc. Prior to joining Akshaya Patra he was Vice President – Sales, Webex Communications (now owned by CISCO). He holds a Bachelor’s Degree in Engineering and a Master’s Degree in Management. In Akshaya Patra, Mr. Shridhar as an Executive Director oversees all the executive functions such as Resource Mobilization, Communication, Finance, HRD, IT and Operations Excellence Initiative.
KAIZEN Story

Once there was a farmer who had lost his watch in the barn. It was not an ordinary watch, because it had sentimental value for him.

After searching high and low inside the hay for a long while, he gave up and enlisted the help of a group of children playing outside the barn. He promised them that the boy who found the watch would be rewarded.

Hearing this, the children hurried inside the barn, went through and around the entire stack of hay, but could not find the watch. Just when the farmer was about to give up looking for his watch, a little boy went up to him and asked to be given another chance. The farmer looked at him and thought, why not? After all, this kid looked sincere enough! So, the farmer sent the little boy back in the barn. After some time the little boy came out with the watch in his hand….

The farmer was both happy and surprised! He asked the boy how he succeeded where the rest had failed. The boy replied, “I did nothing but sit on the ground and listen. In silence, I heard the ticking of the watch and just followed the direction of the sound.”
Moral from the story

- A Peaceful mind can think better than a Worked up mind.

- Allow a few minutes of Silence to your mind every day, and see, how sharply it helps you to set your life the way you expect it to be...

- The challenge is to silence the mind....

Please share your feedback / suggestions for improvements to dsoneji@kaizen.com