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Spring 4-2008

## Lean Accounting Best Practices

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### Recommended Citation

Haber, Jeremy Paul, "Lean Accounting Best Practices" (2008). *Chancellor's Honors Program Projects*.  
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Honors 443

April 24, 2008

### Lean Accounting Best Practices: An Application of Transaction Cost Economics

Famous writer Oliver Wendell Holmes once said: "The greatest thing in the world is not so much where we stand, as in what direction we are moving." If only today's CFOs would listen to Holmes' advice. Instead, CFOs are more inclined to manipulate the company's financial position for the short run, even though they should be thinking about the long run and focusing on continual improvement and bettering business processes.

However, around the world some CFOs have caught on and are beginning to better their business processes, especially in accounting, by adopting best practices and lean management. By adopting both lean accounting (lean management specifically applied to the accounting department) and best practices, firms will be able to reduce organizational costs and lower transaction costs, thus preparing the company for the future, and, in the long run, the company will become more profitable, competitive, and reactive to change.

The paper will be broken up into three sections. The first section of the paper will give a brief background of Coase's theory of the firm and transaction economics. Then there will be a general overview of what lean accounting. Also, in this section, I will discuss two examples of simple accounting cycles common to all manufacturing organization. Next, the body of the paper will analyze how lean accounting can reduce transaction costs and organizational costs. In this

section, the focus will be on how a company can take steps to change certain processes to become lean. It will also show how lean accounting can help eliminate transactions that are not considered important or necessary. Finally, the last section will describe the changing role of the accountant as the change maker.

### **Coase's Theorem**

Ronald Coase studied transaction cost economic theory and in 1931 he published his most famous article "The Nature of the Firm." In the article, Coase's theory was the following: a firm exists to replace high transaction costs with lower organizational costs, and a firm will grow larger when it can minimize organizational costs and transaction costs. What is the difference between transaction costs and organizational costs? Transaction costs include all the resources and costs needed to enter into a transaction. For example, when a company decides to buy a dozen new computers, the transaction costs associated with this order include the time to search for a computer, to acquire information, to write up a contract, and to monitor the fulfillment of the order. (Sampson) Other examples of transaction costs include purchase orders and invoices. In a purchase order, resources are used to find a supplier, write up the order, and monitor the correctness of the order. For invoices, the company's accounts receivable must write up the document, validate the correctness of the document, verify the fulfillment of the payment. Organizational costs, on the other hand, are the costs incurred within the firm without any outside transaction. Examples of organizational costs include material tracking systems, inventory tracking systems, labor tracking systems, and financial reporting activities. For example, a company uses a labor tracking system to help keep track of the time a worker spent on making a product. Then the system calculates a labor rate and applies the cost to the product. Any variance reports or other charts to track labor, materials, or inventory are also considered

organizational costs. Since financial reporting activities do not involve outside transactions, all their costs are considered organizational costs, too. For instance, the time it takes to close the books is considered an organizational cost.

As companies grow, both organizational and transaction costs increase. Transaction costs increase because the company must create more contracts with suppliers and buyers to create more revenue. Organizational costs increase in two ways Coase pointed out. Due to the “decreasing returns to the entrepreneur function,” managers will become more likely to make mistakes as the company grows. Overhead costs also will increase in proportion to the activity of the company. To remain profitable, growing companies look for ways to decrease their transaction and organization cost. A popular solution for companies to reduce both of these costs is to become a lean enterprise.

### **The Lean Enterprise**

Lean is a philosophy that spurred from the Toyota Production System (TPS). TPS was created by Toyota’s founder Sakichi Toyoda, Kiichiro Toyoda, and Taiichi Ohno. Much of TPS was also influenced by W. Edwards Deming’s statistic process control (SPC) and Henry Fords mass production lines; however, the Japanese were not impressed with Ford’s approach because it was filled with over-production, lots of inventory, and much waiting. Toyota identified these weaknesses if Fords production line and adapted the production line to create a more productive and reliable production line. TPS and lean also use Just-in-Time inventory where only small amounts of inventory is ordered and very little inventory is waiting in the production line. This also was very different from Ford’s production line which usually bought high volumes of materials and had high inventory levels to lower costs.

After TPS proved to be successful for Toyota, many companies adapted their production lines to incorporate lean principles. Essentially, the primary principle of lean is lean is a tool used in manufacturing firms to eliminate waste (muda), improve quality, and reduce cost. Waste is eliminated by identifying non-value-added activity. Examples of non-value-added activities in a production line include the following: moving work in process inventory, counting, inspection, rework, obtaining approval, testing, and recording. Although there are some service companies and small manufacturing firms that adopt lean principles, large manufacturing firms benefit the most from adopting lean and lean. However, not all large manufacturing firms are successful in adopting lean manufacturing.

Companies may face certain challenges when applying lean to their production lines. First, lean should be applied to companies that have production lines that are routine, predictable, stable, and can be flow charted. Companies that do not fit these criteria include companies with diverse tasks and are highly creative that don't focus on efficiency. Second, lean implementation may take years and can be very costly in large organizations. Depending on how integrated the systems and how disciplined the production line is, it is quite possible that a lean implementation may fail. Richard Kallage, a manufacturing consultant, explains in his article "Lean Implementation Failures" that lean implementation requires preparation, leadership, training, and well-designed deployment methods. Also stated that over 50 percent of lean implementation projects fail. To prevent this failure, a company needs highly trained management, clear direction, and well stated achievable goals.

Management may also be discouraged to adopt lean manufacturing right away because lean application is long term investment. More and more CEOs are making decisions that benefit the company in the short run, and CEOs may choose not to adopt lean because lean may show

unfavorable results on the financial statement during the early stages. Lean will cause a sharp decrease in inventory levels, causing assets on the balance sheet will drop which is not always favorable. However, these short term negative results will eventually turn into long run gains as the company benefits from less inventory holding costs and improved processes.

### **Traditional Accounting Transaction Cycles**

While most business people associate lean to manufacturing processes, it is now becoming more important for companies to adopt lean throughout the company. A prime example of a support function that uses lean concept is the accounting function. Since accounting is a support department it should apply lean techniques after the manufacturing department has incorporated lean. Accounting's main duty is to accurately measure and communicate financial activity, and so adopting lean accounting before the company adopts lean manufacturing would not accurately measure the company's financial activities. Similarly, most companies forget that they should adopt lean accounting after or while they are successfully implementing lean manufacturing to accurately measure the new production system. If a company still uses old accounting processes after lean manufacturing implementation, then the company will experience a ballooning effect of accounting costs. This is because lean manufacturing increases the volume of transactions between suppliers and buyers to maintain a steady flow of production within the company. Remember, lean manufacturing's goal is to keep inventories low, so the company should buy lower quantities of materials and supplies more often. If accounting didn't improve their processes they will still take the same amount of time to type up purchase orders and to process other order fulfillment documents. A higher volume at the same rate of work creates enormous costs for a company.

Let's go further into the two accounting transaction cycles to show how transaction costs can become great. The first cycle is called the revenue cycle, or the order to cash cycle, and it starts with a customer sales order. This document is then used to check the customer credit and to see if the product is in stock. Next the company creates a picking list and packing list from the customer order. The picking list tells the shipping department what products to pick for the shipment, and the packing list is created by the company and placed in the box to tell the customer what are the contents of the shipment. Sometimes the company may include a bill of lading which acts as a legal contract that identifies who owns the shipment while it is in transit. The invoice is a document that tells the customer how much they owe the company for the products shipped. Usually the invoice is sent with the shipment, but can also be mailed to the customer after the shipment arrives. The customer then sends a check to the company and the company finally deposits the check into the bank. The entire cycle varies in length from a couple days to a couple of months for a typical firm.

The second cycle is called the expenditure cycle, or the procurement cycle. This cycle starts with the purchasing company creating a purchase order or a document that states what products it wishes to order from a certain vendor. A copy of the purchase order is sent to an accounting department called accounts payable, which is responsible for tracking vendor payments. The other copy of the purchase order is sent to the vendor. When the shipment arrives, the company will review the packing slip which tells the product amounts that are in the shipment, and the company will compare the packing slip to the receiving report, a report that shows which products it expects to be found in the shipment based on the purchase order. The purchasing company will note any products that were not shipped on the receiving report and will contact the supplier to see when they expect to ship the rest of the products. The purchasing company

will then receive an invoice that shows how much they owe for the shipment. The accounts payable department will then match the invoice, purchase order, and receiving report so see if the purchasing department has been charged the correct amount. Then the treasury department of the purchasing company will write and send a check to the vendor.

As mentioned before, transaction costs include all the resources and costs needed to enter into a transaction. In the revenue and expenditure cycles, any form of documentation can be considered transaction costs because these cycles deal with buying and selling products with another entity, and these documents require employee's time to write them up and to verify them.

These transaction costs all use time and money of the company but do not add any value to the company. So then why do companies use these systems and documents? Companies use documents like purchase orders and invoices to make sure their suppliers and buyers send and buy what each company requested, preventing any fraud between companies. It also acts as evidence for auditors to test account balances reported on the financial statements. Auditors usually pull samples of certain documents to test internal controls. Auditors may also check to see if there is fraud within the company committed by an employee, however this can be done today electronically without paper documentation.

### **Lean Financial Accounting**

The revenue cycle, the expenditure cycle, and financial reporting are all apart of financial accounting. These financial accounting processes have high transaction costs. However to combat the high costs, companies use a combination of lean accounting best practices, automation, and technology to lower costs. Before describing the various lean best practices

associated with financial accounting it is important to note how information technology assists lean accounting with decreasing transaction costs.

Companies may reduce transaction costs created in the accounting cycles by investing in improved information technology systems. Technologies like Enterprise Resource Planning (ERP) systems, Electronic Data Interchange (EDI), and Electronic Fund Transfers (EFT) , have helped reduce transaction costs in many ways. ERP systems integrate different functions of the business like purchasing and accounting, which allow for purchase orders to be processed quicker and with greater accuracy. Also the ERP system helps considerably when a company has to close its books for the month, lowering time required. EDI integrates two companies systems to allow for automatic processing of purchase requests without any human intervention. In other words, a supplier can automatically ship a specific product when it recognizes that its buyer is running out of inventory, by having EDI linking the buyer's system to the supplier's system. This system eliminates the need to send out an invoice. Lastly, the EFT systems allow for companies to pay their bills electronically with a click of a button rather than using a check. It is very similar to using online banking to pay your bills. Unfortunately not all companies have the resources to adopt these systems and sometimes these systems are very difficult to setup. For those companies who haven't adopted these electronic systems, they may be faced with increasing transaction costs, which will eventually put a burden on the company through increasing costs and decreasing efficiency.

Unfortunately, not all companies have the resources to install expensive systems and the cost benefit analysis may show information technology as a less favorable option. That is why companies choose to implement simple lean accounting best practices to decrease costs in their

accounting cycle. There are two easy fundamental concepts companies are using to decrease costs through best practices.

First, companies identify their major suppliers (expenditure cycle) and buyers (revenue cycle) by using the Pareto rule or better referred to as the 80/20 rule. The 80/20 rule says as a general rule of thumb, 80% of revenues comes from 20% of the customers or for suppliers, 80% of purchases is bought from 20% of the suppliers of the company. Robert Coase in his *Theory of the Firm* similarly states that most companies start out making many short term contracts with a variety of companies but over time there will be only a few long term contracts with “certified” vendors. How does this help reduce transaction costs? Certified vendors make fewer shipping errors and more likely to ship products on time. One downside is certified vendors may sell products at a higher price. In this case a person/computer should analyze all supplier bids judge if it is worthy to continue purchasing from the certified investor.

Second, the process matching supplier invoices to purchase orders is very time consuming for the accounts payable clerk, so some companies use blanket purchase orders. A blanket purchase order is a contract with a company that lasts about one year, which covers all expected purchases from a supplier. This reduces the amount of work done by the payable clerk because there are less purchase orders on hand. Usually the 80/20 rule is applied to certain vendors first and then the companies enter into a blanket purchase agreement. Similarly, to reduce the amount of invoices, the company can decide to pay suppliers at the end of the month based on the monthly statements.

After the certified suppliers are in place and deliver the correct amounts of product with high quality and reliability, the final step will be to eliminate the use of invoices entirely. Most

traditional companies report materials when purchased under inventory and either pay with cash or credit. Lean companies on the other hand, derive costs from the bill of materials (list of materials from engineers) not the invoice, and assign costs after the product is completed or sold, not when materials are purchased. This eliminates all inventory accounts during the period because all costs are charged to Cost of Goods Sold. At the end of the period, the costs are then assigned to products through backflushing, where standard costs (predicted cost of materials) are applied to all materials and create an inventory account and a conversion account amount. Backflushing assumes that there is very little labor variances and work-in-progress, common in most lean firms.

Kennedy and Brewer mentioned in their article “The Lean Enterprise and Traditional Accounting” that there are many limitations with traditional product costing. For instance, traditional product costing arbitrarily allocates manufacturing overhead products using volume-based drivers, it ignores relevant nonmanufacturing costs, and relies on standards that may be outdated or inaccurate. Maskell explained that lean accounting uses value stream costing which focuses on the entire value stream instead of focusing on an individual product. Value stream costing also does not deal with standard costing, so variance reports are not needed. The drawback to using value stream costing is that there needs to be great control over the rate of output. Also the company should be in the last stages of lean implementation. For companies that have not fully implemented lean, Maskell says a standard cost (almost near actual) is used. As the company gradually becomes leaner and after the company mapped out all the value streams then the company will use value stream costing. Since most companies have not implemented value stream costing in its entirety, the uses this intermediary standard cost approach.

The last and easiest best practice to implement in the accounts payable process is implementing Electronic Funds Transfers (EFT) along with electronic invoices. EFT make it so companies don't need to write checks between companies and allows for quick payment of invoices.

The implementation of certified suppliers, coordinated inventory systems, electronic fund transfers, and payments through backflushing will greatly reduce the amount of transaction cost that occur in the Accounts Payable process. According to INC.com, AICPA conducted a study that an average billion-dollar company processes 12,500 invoices per accounts payable employee annually at a cost of \$3.55. An efficient company using some of the best practices listed above process invoices at \$0.35 each, saving about \$40,000 per accounts payable employee the same study stated.

The changes in the accounts receivable process are what we wanted our suppliers to implement in the accounts payable process. The goal for the lean company is to reduce purchase orders, become certified suppliers, and include invoices with shipping documents. The first mission of the company is to become certified suppliers to their main purchasing companies. Again, using the 80/20 rule, the company can identify their top purchasers and then coordinate with purchasers a plan to use blanket purchase orders. This will help reduce the wasteful processing of purchase orders for each order. Another great way to speed up the accounts receivable process is to include the invoice with the shipping documents, and then encourage purchasers to pay for the materials upon receiving them. For example, Wal-Mart orders Kleenexes daily from Kimberly Clark, a certified supplier, through their automated EFT. Wal-Mart, upon receiving the Kleenexes and invoice, then automatically deposits the amount on the invoice into Kimberly Clark's bank account. For a typical company, the accounts receivable process may take 15-45 days, but for Kimberly Clark the process is completed in one day. Just imagine the chaos if

Kimberly Clark delivered to Wal-Mart daily but didn't use this lean accounting system. The transactions would be overwhelming and costly. It is also important to point out that there must be great coordination between sales, order processing, and the accounts receivable departments in order for the blank sales orders process to work.

Closing the books is also an extremely time consuming process. For a traditional company, the more departments a company has, the longer it takes to close the books. During the closing period, accountants must check each trial balance by account to see if amounts on the financial statements will be accurate. To reduce the time to check these trial balances, accountants should clean up the chart of accounts by eliminating accounts that the company doesn't use anymore. Many accounts are not eliminated because managers are scared that their report or analysis will not be accurate, but the manager should ask if the report or analysis is really necessary. Asking these simple questions will easily reduce the amount of time it takes to close the books.

### **Cost Accounting Best Practices**

Unlike financial accounting best practices, cost accounting best practices reduce organization costs rather than transaction costs. Organization costs are expenses that occur within the company and are not related with outside partners. Some common examples of organization costs include: labor tracking, materials tracking, and inventory tracking. The company can apply lean best practices to each of these tracking systems to reduce the costs associated with each of them.

Traditional companies have cost accountants track all materials and labor in detail. On the other hand, lean companies do not track materials or labor and instead expense these costs rather than

transfer them into an inventory account. It is very important to keep inventories very low and material and labor variances very small.

It is important to remember that most of the time lean accounting should come after lean manufacturing. In other words lean manufacturing must be in place before steps in lean accounting can be adopted. Production line managers should focus on these lean manufacturing improvements, then accountants can change parts of the system.

Depending on how far the company is with lean manufacturing determines the extent to which labor tracking, material tracking, and inventory tracking can be leaned out. The first best practice a company should adopt would be to eliminate job step tracking. Job step tracking records the time spent on a job. Similar to backflushing, lean accounting uses a standard estimated cost and multiplies the cost by a standard rate of work in the production line. Employees then will only need to record their start and stop times. Any deviation from the standard work rate to complete a job, then a blinking light (Andon Light) will signal others in the production line of a slowdown in the line. Labor should not deviate much from predicted rate

The second step to take in the labor tracking system is applying backflushing. The production line knows the amount of the standard number of hours to make a product or part at a standard rate per hour. Instead of tracking cost on each work order, the costs can be applied at the standard cost of production. Having one less item to track in the labor tracking system reduces errors and costs in the labor accounting department.

The third task is to get rid of variance reports. In the traditional company, variance reports measure the difference between actual and standard costs, pushing for maximized efficiency. But

in the lean enterprise, efficiency isn't the goal, making variance reports not of any value. In most cases, variance reports during lean implementation will show negative performances due to the lower machine use and lower actual volumes of materials. Instead a board which shows the standard labor rate (day-by-the-hour) and the actual labor rate. Ultimately, the goal is to have standard labor equal actual labor.

Like labor tracking, the first best practice to implement is to reduce the use of variance reports to monitor actual material costs against standard costs, because lean companies eventually become very standardized and have little variation. Lean companies, on the other hand, get rid of these variance reports and instead use the standard cost of materials only. Materials tracking also uses backflushing. Again, only companies who have accurate bills of materials and material routings can use this way of costing. In addition, accurate records of material scrapped is necessary since they too will be added to standard costs.

The last system to lean out is the inventory tracking system. Tracking inventory is important especially because inventory must be reported on financial statements at the end of the accounting period. Traditional companies keep detailed records of movement of raw materials, work-in-process, and finished goods. The old way of tracking inventory creates many transactions each time there are receipts, issues, adjustments, and miscellaneous adjustments. Again, to help limit these transactions, backflushing should be implemented. Then to test the accuracy of bills of materials and routing, samples of the process should be conducted periodically. This is called cycle counting, and should replace the old and costly physical inventory counting process. Cycle counting will test the accuracy of the processes that create inventory balances. They are also less disruptive to operations and can be tailored to focus on higher value inventories. The end goal for a lean company is to have no inventory thus no

inventory tracking, however if inventory should still occur then costs will be applied by the standard rate through backflushing. This is for financial reporting use.

Implementing lean in the labor tracking, material costing, and inventory tracking systems will greatly reduce the amount of waste in the company and help reduce organization costs incurred by the company.

### **Disadvantages of Lean Accounting**

GAAP does not recognize lean accounting as a proper accounting reporting method. Instead companies must use the traditional absorption income statements where product and period costs are separated, whereas lean accounting segregates the income statement into value streams. (See Appendix I) Merwe rationalizes that lean accounting in “full deployment is premature until there is more technical depth and understanding as to how it supports operational decision making, strategic planning, and external reporting.”

There are many advantages for applying lean thinking to organizations. As noted, many companies can greatly reduce their resources wasted on many tracking and accounting processes, thus allowing these highly skilled workers to become leaders and change agents for the company they work for. For many companies, lean implementation has cut transaction costs greatly and has reduced waste drastically. On the other hand, there are some disadvantages to lean implementation. Many companies race to implement these big changes and fail miserably. Lots of time and money are spent on new systems but end up not working. Another disadvantage to lean implementation is the susceptibility to more risk, especially in the supply chain. Originally, companies had a broad base of suppliers with a long and wide supply chain; however, as the

company weeds out suppliers, shortens their supply chain, and begins to only certify a few reliable suppliers, the supplier base becomes less diversified.

### **Conclusion**

Lean accounting is the newest buzzword in cost accounting. For companies who are deciding what direction to move forward, lean and lean accounting should be considered, just like considering going global or investing in information technology. The nature of lean is to cut out the waste in a process and by doing that lean gets rid of transaction and organization costs.

Although cutting costs is usually the most common way for increasing profit, lean companies should not forget about increasing revenues through marketing. Lean thinking is process driven not number driven, which makes it different from other cost accounting methods. By improving the process within the company, profits, although not guaranteed, should follow in years to come.

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Appendix I

TRADITIONAL INCOME STATEMENT		LEAN ACCOUNTING INCOME STATEMENT				
	TOTAL PLANT	VALUE STREAMS			TOTAL PLANT	
		Window Units	Fence Rails	Outside Storage		
Sales	\$ 605,773	\$ 200,456	\$ 154,879	\$ 180,438	\$ 605,773	
Cost of Goods Sold:						
Beginning Finished Goods Inventory	\$ 120,525					
Cost of Goods Manufactured	\$ 375,340	82,435	72,540	65,439	\$ 220,414	
Cost of Goods Available for Sale	\$ 495,865	42,892	36,462	18,420	\$ 97,464	
Ending Finished Goods Inventory	\$ 133,478	22,704	8,560	5,786	\$ 37,050	
Gross Profit	\$ 243,388	21,500	16,420	9,005	\$ 46,925	
Other Operating Costs	\$ 125,671	36,450	25,430	25,468	\$ 87,348	
Net Operating Margin	\$ 117,715	Occupancy Cost	32,500	8,452	12,534	\$ 53,486
SG&A	\$ 58,760	Change in Inventory	(13,458)	8,578	(18,432)	\$ (23,312)
Net Profit	\$ 58,955	Value Stream Profit	\$ 65,733	\$ (21,553)	\$ 42,218	\$ 86,398
Plant ROS	9.7%	ROS	22.6%	-13.9%	26.3%	14.3%
				Unallocated Occupancy Cost	8,573	
				Corporate Overhead	18,870	
				Plant Profit	\$ 58,955	
				Plant ROS	9.7%	

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