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A supportive foundation for **lean excellence**

Herman Miller, Inc.'s people-centric focus

PAGE 12

Finding the right engagement **strategy**

PAGE 8

A story of **leadership**

PAGE 18

Secrets of their **success**

PAGE 23

Finding the right ENGAGEMENT STRATEGY

The importance of a lean-minded board of directors

BY JAMIE FLINCHBAUGH AND ORRY FIUME

The board of directors (BoD) of any company, large or small, public or private, is an influential factor in the direction of an organization. The lean community is quick to point out that the senior leadership of an organization must get on board and start to lead lean, but is conspicuously quiet when it comes to the role of the board.

During 2015's The Summit on Lean Leadership, a conference hosted by Lean Frontiers and the Lean Leadership Academy, Jamie Flinchbaugh was asked to lead a discussion on this important role in leading lean. There were several in attendance, but the most experienced audience member on this topic was Orry Fiume.

As a result, we have teamed up to summarize our discussion on the role of the board of directors in leading lean.

Why this matters

The BoD is an influential part of the organization, both as an intact unit and as individual members. They affect strategy, culture, incentives, leadership selection, capital allocation and much more. When lean was mostly applied as a shop-floor organization or cost-reduction program, there was no need for the BoD to engage. But "shop floor lean" is not lean. Shop floors make lean very visible and obvious, and many of the early applications were in manufacturing, but this does not make one a lean organization.

As lean has matured to more frequently be realized as an overall strategy and the core of a company's culture, the lack of involvement from the BoD becomes a concern. The BoD is increasingly not just an approver of the strategy, but is engaged in its development. Lean is a strategic choice; it determines how you move forward as an organization, and like any strategic choice, it determines your future and requires many supporting decisions at all levels to bring it to fruition. Furthermore, although BoDs don't directly build culture, they influence it through means such as compensation systems and reflect it in the hiring or firing of CEOs based on the right culture.

Framing the discussion

There are three primary aspects in how we structured the thought process and discussion about lean and the BoD. First, the BoD must be educated and informed about the what and why of lean, the company's lean strategy and the results. Second, they can also be direct benefactors of lean by applying lean thinking to the board process itself. Third, they can contribute to the lean journey through very specific actions that they own without breaking the barrier into managing the company. Each of these aspects is important and useful independently, and even more so when they reinforce each other.

Informing and educating the board

There are so many things about which management must keep the board in the know that adding one more thing can be distasteful to both parties. Recently, in a discussion in a workshop with the National Association of Corporate Directors, there was a conversation that generated a list of topics on which the board should spend 10-30 percent of their time. The list was 13 topics long, which takes you to 130-390 percent of capacity. The average number of hours worked by board members has been increasing, reducing the willingness and availability of high-caliber resources to join a BoD. Why should they learn about what the company is doing with lean as well?

During the financial crisis, lean suffered and then benefited from an identity crisis. Many companies said they were doing lean, and had committed resources to the effort, but these efforts were not lean. They were largely cosmetic efforts in order to say, "We were doing lean." With revenue and resources constrained, they had to make a choice: Cut the lean effort altogether, or commit and make it strategic. Some companies (not many) made the latter choice, and lean became a means to achieve the strategy of the company, even if that strategy was simply survival at the time.

So now lean matters. It affects financial budgeting decisions, capital allocation decisions, leadership structure, incentive pay and much more in which the BoD already gets involved. If the BoD does not understand lean, or the company's lean efforts, each of their inputs or decisions will be, quite simply, uninformed and work against the company's lean strategy. This is particularly true when it comes to the impact on the financials. Especially in a manufacturing company, you would often see a dramatic increase in inventory turns, and see material differences in your capital spending and overhead absorption. These would have net positive effects on cash flow, but will, in the short term, negatively affect profits. This isn't a real negative impact, but a calculated one.

During Wiremold's lean journey, the company acquired multiple entities and each time, there was a need to take a substantial noncash charge in the first few years due to inventory reductions. Under Generally Accepted Accounting Principles (GAAP), when product is built, but not sold, the cost associated with that product must be capitalized in inventory. The labor and overhead portion of this is a noncash credit to the current year's P&L. Conversely, when inventory is reduced, a noncash charge must be absorbed. This is hard enough for a private company board to understand and support, but significantly harder for a public company board, since this noncash charge also reduces earnings per share (EPS).

Overall, the board may not need to contribute to the lean journey, but they must guide and advise the company consistent with where it wants to go, and ensure that its decisions or communications do not become a hindrance to the lean efforts.

What is the best way for a BoD to understand lean? Certainly, given their limited capacity, the multi-day coursework isn't likely to be successful. The simplest means may be to recruit lean expertise onto the board. This is what Art Byrne did when he joined Wiremold as its CEO. And both authors have had that experience of being recruited both for their overall capabilities along with bringing lean experience into the board room. When a board has a peer that

Jamie Flinchbaugh leads the discussion with Orry Fuime.

understands and supports lean, it is much easier to accept the counterintuitive things that must be done during a lean transformation.

Books, online training and other tools that can provide a base of education for directors are useful, but should be done on their own as part of their often-large reading and preparation pile. The company's education efforts for directors should focus on exposure to real applications inside the company. Expose them to what employees are applying and accomplishing and, just as important, what barriers they face. Conducting plant tours so that they can see the improvements that are taking place and having those improvements explained by the people doing the work goes a long way to building the board's trust in the lean strategy.

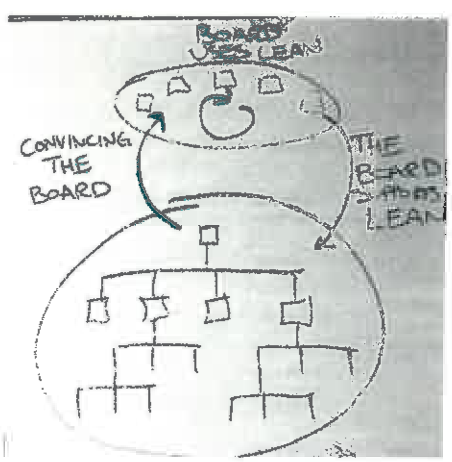
Applying lean to the board process

Most people think of the BoD as only an entity, but there are many processes where they are either the centerpiece or involved, and if you look closely you notice these processes are rarely lean.

In one case, Jamie observed a senior management team put approximately 1.5 weeks going through 3-6 iterations of PowerPoint slides just to prepare for a board meeting. With four meetings per year, that's six weeks of management time and more importantly, their attention. Just like any other process, when lean is applied, you can achieve shorter lead times, less waste, better quality and a clearer purpose of success.

This particular process is an interesting example of disconnects in communications with customers and suppliers. As the management prepares their board book, in many cases, it is filled with extraneous details that are important to the management but aren't useful for what the BoD is trying to understand. Just by cleaning up the customer requirements of the process, and not delivering to the BoD materials that are not needed or wanted, waste is eliminated from both sides of the equation.

There are many more applications, both with the BoD as a customer and how it operates itself. For example, a core principle of lean is direct observation, being able to understand the current reality of a situation based on real facts. The BoD often relies on heavily filtered information, but there are opportunities



The cycle of BoDs' support of lean.

for the board to get closer to real facts. This would include useful tours of operations, interactions directly with customers, engagement on a topical basis with management team members and so on.

If the tools and processes used by the BoD aren't clearly defined and purposeful, they can create waste for the board members, the management team and the company as a whole.

How the board of directors supports the lean journey

The purpose of BoDs is oversight, not operational decision-making. The BoD should not have too much influence over the direction of the organization's lean journey. The guideline of "noses in, fingers out" that applies to the role of the board applies to lean as much as anything else. But there are a few elements that the BoD holds closely that can have a tremendous positive affect on the success of lean efforts.

The first, and greatest, impact that the BoD can have is through strong succession planning. Lean is most effective when you can sustain the journey for more than five years. It's not a quick-hit and done kind of strategy. That means that the lean journey often exceeds the tenure of most senior executives. In fact, in our experience, the next leader often contributes more to the lean journey than the initiating leader. So ensuring that you have someone in place to take the baton and continue the race is essential to the success of the lean journey.

On the flip side, if the succession planning is not strong and the BoD has no option but to go outside and find someone new, it is too often a killer to the momentum. Many succession plans assume the new CEO will come from the outside, and it does not help that many advisors in this area are search firms who make their money from bringing in new people. In the worst cases, the new CEO will put an outright stop to the efforts, not fully understanding the benefits but only able to see the costs of the effort on a budget. While it is rare that the new CEO will make this type of overt decision, there are a lot less direct ways where the "new leader" leads to a dramatic loss in momentum.

While waiting for the new leader to come in, grasp the situation and establish the direction, people begin deferring decisions large and small. Lean efforts fade into sustainment at best, but certainly no big changes are made, as no one is sure whether they are desired. In addition, when customer service issues arise (and they always do), the solution becomes "add more inventory" rather than the kaizen approach of finding the root cause and fixing the problem. Lean can die a slow death.

Succession planning is generally already high on many BoDs' lists of priorities, although likely not enough, whether they are on a lean journey or not, but its value is amplified with lean. Internal promotion should be a board priority. There are many opportunities to enable this, including having the next generation of management present their improvement efforts to the board through which they will become familiar with the depth in the organization. Using board members as mentors for future candidates both develops the organization and creates visibility into the organization.

A second area that does not get enough attention, unless things go terribly wrong, is accountability for the culture of the organization. BoDs are responsible for establishing, often in partnership with management, the right accountability and incentive criteria. This is a hot topic in the circles of corporate governance, and for good reason, given the string of cases of executive making millions while the companies they manage go down the tubes. There is still a lot of focus, and quite frankly too much focus, on finding the right financial metrics to tie to incentive pay, whether it is earnings before interest, taxes, depreciation and amortization (EBITDA) or pure revenue or total shareholder return (TSR).

Knowing that all financial metrics are inherently lagging metrics, more companies are attempting to tie incentives and accountability to the strategy of the company. Both the development and execution of the strategy should be indicators of future financial success. But strategy isn't enough. Most thought leaders recognize that culture trumps strategy. A good culture can carry a company and become its competitive advantage, allowing strategic options that weren't available before. And a bad culture can kill a company no matter how good a strategy is in place. So many famous company failures were truly failures of culture, from the emblematic Enron to the more recent Volkswagen.

Boards rarely hold management accountable for culture, unless there is a failure requiring a CEO's dismissal. In part, we lack the tools to effectively and consistently do this, but we shouldn't shy away from engaging in the truly important because it is difficult. Presenting to the board, mentioned earlier, is one way for the board to assess the culture. More focused data-based survey tools also allow the management team and the board to evaluate whether management is getting what it wants from the organization it is attempting to lead.

Holding management accountable for culture is even more vital if lean is to be the cornerstone of a company's success. While lean is still too often only about tool application, more and more are recognizing that lean is a strategy that truly recognizes that people are a company's most important resource and fosters continuous learning, through experimental-based problem solving (kaizen). This influences behaviors throughout the organization, and more importantly, builds common and consistent behaviors that become the basis for a truly effective operating system. If this is only an afterthought to short-term financial success by management, it will be hard to build a sustainable lean journey. The BoD can greatly influence this through accountability and incentives.

Behind CEO selection, there are few levers the board controls that have a greater impact than compensation. This topic is generating massive attention in board and governance circles, although there is far greater attention on regulation and transparency, which is needed, than how we truly tie incentives to the desired behavior. Most big pushes, such as TSR, are well intentioned but filled with nuanced contradiction and potential for manipulation.

Wire and cable management company Wiremold provides one example of how we can positively affect the focus of management through careful design and selection of the compensation scheme. Wiremold had operated from a quasi-MBO (management by objective) approach. When lean thought leader Art Byrne came in as CEO, he immediately changed it. Everyone on the executive team moved to a compensation system that included incentive compensation that was based on shared company goals, and either everyone succeeded or no one did. The incentives were focused 40 percent on operating income (i.e., operating efficiency); 40 percent on working capital (a major component of capital efficiency); and 20 percent on successful achievement of the company's hoshins (current strategic initiatives). With this balance, even in a down revenue year, the team was still able to improve cash flow and the balance sheet, both critical to the future of the company and earn some incentive compensation. In the dot-com crash of 2000, even though sales were down 14 percent and operating income was down 25 percent, through continued improvements in inventory turns and accounts receivable days outstanding, cash flow improved 22 percent.

How to get started

While these three areas of engagement all matter, you will have to start somewhere. But the very first piece of the puzzle is the right engagement strategy. This will depend greatly on your role:

A kanban board representing the cycle of BoDs' acceptance and implementation of lean.

Are you leading the lean journey, are you the CEO or are you on the board? Regardless of your role, it helps to start with even a single ally and chart a course of engagement.

This plan must be sympathetic to the current focus and bandwidth of the board. It is unproductive to insist that it move to the top of their priority list or that they go through intense training. Instead, integrate into their process and priorities to gain a foothold, and then build the engagement one deliberate step at a time. But any means you can use to get started will be a step in the right direction.

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