Are You Properly Classifying Your Lean Six Sigma Project Financial Benefits?

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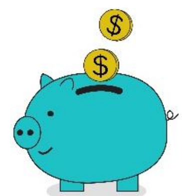
One of the challenges we face in evaluating the outcomes of a Lean Six Sigma (LSS) project is how to compute and determine the financial benefits of the project. While it is not mandatory to always have a direct financial benefit, leadership often relies on those savings to justify the continued deployment of an LSS effort or its expansion in the organization.

Three common classifications used for capturing financial benefits are direct cost savings, cost avoidance and cost deferment. I will define each in simplistic terms and provide three scenarios which will allow you to determine whether the financial benefits of a project were properly defined.

Cost Savings



Cost savings refer to the reduction of **actual expenses** compared to a previous period or compared to what was originally budgeted. This is a **tangible reduction** in expenditure, leading to an immediate and measurable impact on the bottom line.

Cost Avoidance

Cost avoidance involves actions that prevent future costs from occurring. Unlike cost savings, cost avoidance does not reduce current expenses but prevents possible increases in costs in the future. It often involves decisions and actions to mitigate potential cost increases or theoretical future expenditures.

Rather than reduce the cost of an item or service you're already paying for, you avoid paying the cost **altogether**. This is why cost avoidance is often referred to as "soft costs" or "indirect costs." This is because unlike cost savings, which you can quickly identify in your financial statements, cost avoidance isn't typically quantifiable.

Cost Deferment

Cost deferment refers to postponing expenses to a later period. This does not eliminate the current cost but delays its impact on the financial statements. If there is a probability you may need to incur the expense in the future, then you are merely pushing it off to some future date. And it is likely that the current expense you have delayed may cost more in that future time period.

Comparison

- **Timing of Impact:**
    - Cost Savings**:** Immediate impact on reducing current expenses.

    - Cost Avoidance: Impact on future expenses by preventing cost increases or potential future expenditures.
    - Cost Deferment: Delays the impact to a later period without reducing the total cost.

- **Nature of Impact:**
    - Cost Savings: Tangible and measurable reduction in current costs. This is money you can conceivably spend elsewhere.
    - Cost Avoidance: Intangible and often not directly measurable in the present but critical for long-term financial health. Don't spend what you don't have.
    - Cost Deferment: Temporal shift in cost, useful for short-term financial relief but not a reduction.

Here are three scenarios where the President of an organization had to decide how to classify a potential financial benefit. See if you agree or disagree with the President's classifications.

Background:

After a concern was raised about the structural condition of a large warehouse, the President, Naythan, hired a structural engineer to inspect and assess the condition of the building. He identified an area that was not in compliance with local building codes and suggested that the issue be addressed soon.

There were already plans to do some structural work in the near future so Naythan decided to hold off on any action until the planned construction started with the intent that the code violation would be dealt with at that time. The Board of Directors agreed with Naythan and the issue was temporarily put on hold.

Once the construction project began, Naythan tasked a small group to start investigating possible solutions to the code violation, potential contractors who could conceivably do the work and solicited estimates of possible costs. These "ballpark" estimates ranged from $750,000 to over $1,000,000. At this point, there were no definite solutions, only concepts. Three contractors were brought in to assess the potential project, but no contracts or formal proposals were made.

Unfortunately, Naythan was replaced by a new President, Joyce, who now had the responsibility for addressing the code issue. At this point, there were no immediate life/safety issues with the code violation. Joyce knew that there would be code inspections for the rest of the construction, so she decided to temporarily halt the information gathering process and wait to see if the code violation was picked up during the other inspections. If so, she would deal with the issue then. If not, she decided that she would not do anything about it.

During a Board of Directors meeting, Joyce was asked about the issue of code violation. Here was what she said: *“I have decided to suspend the further gathering of information on the issue and therefore I saved the company over $1,000,000.”*

My question to you is, **“Was this a cost savings?”** I say **NO!** There were no tangible actual savings. Why did she select the highest expense estimated by the contractors? Can that $1,000,000 be removed from the construction budget? No, there was no line item in the budget since everything was in the early planning stages. Can Joyce spend that $1,000,000 elsewhere? **NO!** What do you think?

In trying to backoff her original claim, Joyce then classified the postponement of gathering data as a **cost avoidance** of over $1,000,000? Is she right? I say **NO!** Was the possibility of a future cost eliminated? Was the underlying issue of the code violation solved? Will that show up in the bottom line or the financial statement? Can the company spend that money on other priorities? Can Joyce claim any financial benefit or savings by calling it cost avoidance? I say, **NO!** What do you think?

There were some financial staff who took exception to Joyce calling the $1,000,000 either cost savings or cost avoidance. They felt it was more accurate to define it as a **cost deferment**. Their reasoning was that the underlying problem was not solved and there could be a future expense should the code noncompliance be identified by the future inspections of the rest of the job. Likewise, if the condition of the noncompliance deteriorated it also might result in an increased future cost. Finally, there is also a possibility that the code could be revised making mitigation more difficult and expensive. The probability of these was not zero and given the uncertainty, the future cost could exceed $1,000,000. What do you think?

In retrospect, I believe it might have been wise not to say anything other than that the decision had been put on hold for now. Do you agree?

Summary

Cost savings, cost avoidance, and cost deferment are different strategies used to manage expenses, classify LSS projects and financial planning. Cost savings provide immediate reductions in expenses, cost avoidance prevents potential future cost increases or expenditures, and cost deferment postpones expenses to manage current financial constraints. Each plays a distinct role in comprehensive financial management and determining the benefits of LSS activities and projects.

If you and your organization are involved in a Lean Six Sigma deployment, you will be facing the same issue for all your projects. Be careful you don’t assign financial benefits to projects that can’t be justified and supported.