Outlook on the Cost Reduction Decision, the Component of an Effective Corporate Governance

Florin Boghean
"Ştefancel Mare" University of Suceava, Romania
florinb@seap.usv.ro

Abstract

Cost reduction represents a constant concern in the field of management. This research presents both the results of an empirical study on six cost reductions programs, as well as the results of a complementary survey carried out in several organizations.

The research took into account the used control mechanisms, the potential factors that occur in themechanismselection, in costmodelling, as well as the part played by management accounting. Through research it can be demonstrated that organizations use certain mechanisms in order to control cost reduction.Nevertheless, it was noted the existence of a particular preference in favour of an action in the context of cost commitment to the detriment of the traditional approaches of measuring and establishing specific costs. This trend is emphasized in the organizations that have outstanding cultural and technological features. It was also noted that organizations use conflicting models of analysis and transposition of cost behaviour.

Keywords:decision making process, costs, governance
J.E.L. classification:G31, G34

1. Introduction

The globalization of entities operation, the development of new information and communication technologies have created a new environment that lays at the root of the new economy, that has demonstrated its fragility precisely through the most active instrument, bymeans of which information circulates. The extraordinary growth of the communication facilities favoured trademultiplication, based on production capacities withreduced costs of the workforce.This increase led to delocalisation, especially in Western Europe, thus threatening theindustrial, commercial and traditional service models with allits consequences on the political, social and human arena. On a background of marketinstability and growing competition, the trends' validity, customers'disloyalty, organizations' vulnerability, uncertainty of tomorrow, etc., all impose upon managers to deal withsituations of unknown complexity and difficulties established by a constantly changing world. Under the double constraint of competition pressure and demand diversification, companies experience nowadays the need to come to a better knowledge of their costs.Only this would explain the development experienced by management control and its privileged instrument, the analytical accounting ("management accounting" or "managerial accounting", the latter being the Anglo-Saxon term), thatcan't miss from anycompanythat wants to last.

While financial accounting reflects the company's transactions' interconnection according to specific rules where theseoperations were recorded, management accounting reflectsaccurately the entity's internal operations that determine the trends, informing the management and serving the internal control of procedures.(Edmonds *et al.*, 2007, p.4-5).Management accounting records the rational correlations of the tactical and strategic decisions, as well as their consequences.(Chorafas, 2006, p. 187)

In order to face the uncertainty and the complexity of the modern world, a new corporate governance approach appears,that takes into account not only the need to inform and satisfy the requests of the shareholders, but also the entity's ability to positively answer to the new restrictions issued on the market by external agencies, staff and their representatives, public opinion etc. An entity shall not only be appreciated according to various economic or profitability criteria, but also through its ability to adapt and react, through its ability to meet the aspirations of the people that use them, through the exemplary attitude towards general interest topics (ecology, ethics, persons'inspection, the rejection of any kind of discrimination etc.), in a nutshell, the ability to become a citizen of the world.

Such corporate governance emerged in the Western society,withproven democratic culture,prosperous andrich and that by dynamism and will to impose have created the conditions for globalization.Its aim is to make a profit, to favour creativity, to respond to the challenges of globalization, to focus more on creation, innovation, research, marketing, as well as on production (delocalised to countries with low workforce demand). The technological outburstand the globalization of trade led to the development of a knowledge economy in which societies differ throughtheiragility, innovation andmobilization ability.

This article presents the results of a research study that took into consideration the way in which entities approach the challenge of cost reduction. More precisely, our study focused on three specific issues:

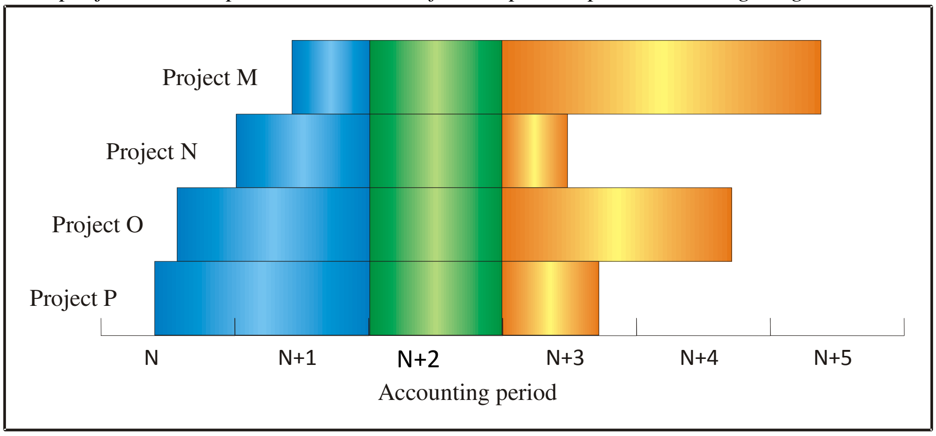
- What are the control mechanisms applied forcostreduction?
- What are the factors that determine the execution of capital budgets used to obtaina cost reduction?
- What is the role of corporate governance?

2. The budgeting of capital expenditures

The decisions concerning the capital investment that are of a strategic nature require managers to take into consideration a wide range of factors that might be difficult to estimate. Some strategic investments are made to avoid the company's disadvantagein terms of competition. For example, when mobile phone companies addcharacteristics to their services that allow customers to connect to the Internet in order to send and receive messages by the electronic mail, a company that does not offer such a service can suffer a decreasein its market share. The benefit of the investors of capital in this case is not represented by a greater income, but by the prevention of arevenues' and profits'decrease. It's difficult to quantify these benefits.

Managers are constantly facing with the challenge of balancing the long term factors and the short term ones.(Swain *et al*., 2006, p.797). The figure below illustrates two different dimensions of cost analysis: (1) the project size is represented on the horizontal and (2)the accounting period on the vertical. Each project is represented by a distinct rectangle with the horizontal edge determined bytime. Each project starts and ends at different moments and are in progress in different time periods, longer than a year. The budgeting of capital expenditures often focuses on the analysis of each project during its deployment by taking into consideration all cash flows or savings resulted fromtheinvestments in that project. On its vertical, the rectangle represents the dimension ofthe determination of profits and planningand of the control established for all the projects.

Figure no.1.The project and temporal dimensions of the capital expenditure budgeting



Source: (author's own elaboration)

The budgeting of capital expenditures' stage: the budgeting of capital expenditure implies making long-term planning decision for the investment in projects. Capital expenditure budgeting represents a tool of decision and control applied over a period of several years. The budgeting of capital expenditures has six stages.

- *The identification stage. The types of projects directed at the capital expenditures necessary for the achievement ofthe organization's objectives and strategiesare determined*. For example, a strategy for product differentiation in order to increase profitability can be promoted through the implementation of projects for the development of new products, for attracting new customers or for entering on new markets. Another solution could be the implementationof astrategy of cost leadershipthat can be promoted through projects that improve productivity and efficiency. The identification of the types of capital projects in which to invest fallsmostlyunderthe responsibility of the operational level manager and should always be guided by the organization's objectives and strategies.
- *The research stage. The analysis of the alternatives regarding the capital investments that would result in the achievement of the organization's objectives.*Multifunctional teams are formed here from all the directions of the value chain that evaluate technologies, equipment and alternative projects. Some alternatives are rejected from the outset, others are evaluated in all their complexity in the next stage, that of collecting information.
- *The stage of collecting information. The costs and benefits expected from the various capital investmentsare taken into consideration.* These costs and benefits can be quantitative or qualitative. The capital expenditure budgeting focuses on the quantitative financial indicators, but the effects of quantitative and qualitative non-financial factors are also taken into account.
- *The selection stage. The projects that will be implemented are chosen.* The organizations choose projects whose expected benefits exceed the value of the expected costs. The formal quantitative analysis uses decision models based on the expected financial costs and benefits. The managers reassess the conclusions that were reached after the formal analysis, by using their reasoning in order to take into account the non-financial factors.
- *The financing stage. Funds for the project are obtained*. The financing sources include funds generated entirely within the organization (self-financing) or those obtained from the sale of shares and bonds on the capital markets. The financing is the responsibility of the financial functionthat is monitored by the financial director of the organization.
- *The implementation and control stage*. Projects are started and their evolution is monitored. When a project is implemented, the company assesses whether the capital investments fit within the required deadlines and budget provisions. As the project generates cash flows, the monitoring and control include a post investment audit which implies the comparison between the forecasts made when the project was selected and the actual results.

Corporate governance presents a series of implications on management accounting. (Seal *et al*., 2006, p.797). According to it, decisions that lead to profit maximization are taken, this being the aim of the company's owners.

3. Internal control management systems

Why should we buy the components necessary for electronic products made by your company, when these can be produced at a lower cost? By producing components within the company significant savings in costs can be achieved. This seems to be the right choice, isn't it? Maybe not always. Sometimes the transfer price, the price that a division of a company perceives for the product that it provides for other divisions hindersthe managers' activity of purchasing parts from other divisions in the company of unused production within the division that produces those components.

Which company has a more successful management control system: Ford or Toyota? Michelin or Pirelli? The answer is given both by the way in whicheach control system achieves its established objectives, those of supporting and improving the decisions for the benefit of the company, as a whole, from acost efficient perspective and by the way in which the system affectsthe behaviourof the people that apply it.

An internal control management system is a tool for gathering and using information in order to support and coordinate the planning and control decisions within an organization and to guide the behaviour of the managers and of the employees.

The management control system collects and provides information for the management control at different levels:

- *The organization's general level* - for example, stock market price, net profit, investment profitability, the cash flow from the operations, total number of employees, pollution control and community contributions.
- *The consumer's / market's level* - for example, customer's satisfaction, the time required to meet the consumers' demands for certain products and the cost of competitive products.
- *The means of production level* - for example, the costs of raw materials, workforce costs, absence rate and injury rates in certain divisions or economic functions (such as research and development, production and distribution).
- *The individual activity level* - for example, the time and costs associated with the receipt, storage, assembly and coordination with the goods from a warehouse, therejects' proportions, the malfunctions and number of units processed repeatedly on a production line, the number of sales and the revenue(obtained from sales) per employee, the number of deliveries per employee at the distribution centres.

As reflected by these examples, the internal management control systems collects both financial information (for example: net profit, the costs of raw material and storage costs) as well as non-financial information (for example, the time needed to meetthecustomers' changes, the absencerate and accidents). A part of the information, such as net income or the number of deliveries per employee, is obtained from within the company. The other part, such as the stock market price or the costs of the competitive products, is obtained from outside the company. Some companies submit financial and non-financial information in a single report called *balanced scorecard*.

4. Conclusions

The stake of this research is to increase the entities' reaction capacity and responsiveness to essential characteristics: time, quality and cost. This implies: the experience, skills andpersons' expertisemobilization, the establishmentof groups that function due to affinities, the facilitation ofa partial vision upon problems and solutions by means ofinternet forums, the fostering of innovation, the financialresources, the human resources, the labour processes.

The field study confirmed that entities don't use just one control mechanism so as to reduce its costs but rather use simultaneously a combination of mechanisms. However not all the possible mechanisms are used in each of the cases, but varies greatly and the focus is on each mechanism separately. In order for such transformation projects to be accomplished, it is compulsoryfor the entity to be equipped with suitable mechanisms of corporate governance so as besuccessful in several projects at the same time, especially in the area of information systems with a major role in change management;

The greatest difficulty of the approach relates to:*an accurate definition of the role and of the responsibility* among the various entities: central directorates, activities' directorates (business units), geographical directorates, etc., which is very delicate to define, taking into consideration the load of the past, the force of the present and the implications of the future. Veryclear definitions will be provided forthe defining elements, the attributions and objectives of a board of directors, of a monitoring committee, of a project manager, of a user project manager, of anethnic projectleader etc.;*a relationship of trust between directorates and a collegial working attitude,* the possibility of taking joint decisions, with all the difficulty implied when the interests of the participants diverge. The viable relationships are based on respectingthe positions of the others, even if these requirebattles for the centralization or decentralization. These notions have lost much of their meaning when the modern means of communication are being used.

The developments of management accounting, especially the assessment of the financial performance and the strategic accounting techniques, increase the response capacity of the company towards the shareholders, the employees, the customers, the government and the business environment. The social responsibility of the organization ensures a new organizational behaviourthat impliescriticism on the budgeting method as a system of performance management.

5. References

1. Edmonds, T., P., Edmonds, C., D., Olds, P., R., Tsay, B., Y., SChneider, N., W., Milam, E., E., 2007, *Fundamental financial and managerial accounting concepts,* McGraw Hill, New York.
2. Chorafas, D., N., 2006, *IFRS, Fair Value and Corporate Governance. The impact on Budget Sheets and Management Accounts,* Elsevier, CIMA Publishing, Oxford.
3. Swain, W., Garrison, R., H., Noreen, E.,W., 2006, Management Accounting, McGraw Hill Education, London.
4. Seal, W., Garrison, R., H., Noreen, E., W., 2006, *Management Accounting,* McGraw Hill Education, London.
5. Monks, R., *Corporate Governance in the Twenty-first Century – Language of Accountability,* www.corpgov.net, accesed at 10.11.2016
6. Simons, R., 2000, *Performance Measurement and Control Systems for Implementing Strategy*, Upper Saddle River, N.J., Prentice Halls.