

# The Ethos of Cost Management

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***Abstract.** This article describes the ethos of cost management, distinguishing the definition, functions and principles governing cost management. I have emphasized the efforts made by the specialists in the field towards finding a much more complete definition of cost management. The description of cost management principles reveals the current interest of the specialists in this extremely important domain of company management.*

**Key words:** cost management; ethos; principles; management accounting; functions.

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**JEL Codes:** M11, M41.

**REL Codes:** 14B, 14I.

In order to reach the standards and principles that regulate an efficient cost management, we will first refer to the definition, constitution and functions that cost management fulfills.

In Romania, the hard work made in the attempt to expand this domain is revealed in many specialized studies of professors such as Mihai Ristea, Oprea Călin, Ladislau Possler, etc. Their contribution to the development of management and cost calculation represents the starting point in extending the area of investigation of different aspects concerning the instruments used in distinguishing the enterprise performances.

Since the notion of cost management knows a variety of definitions, we will focus on the one that describes the activities involving control, analysis, long and short-term decision-making that leads to creation of value for the clients and cost reduction for products, equipment and services.

Managers make decisions regarding the quantity and type of raw material used, changes in the industrial processes and changes in the product's design. The information provided by the accounting system helps managers in the process of decision making, but information and accounting system do not constitute cost management by themselves.

Cost management includes a much larger area that allows for continuous cost reduction. Planning and cost control are automatically connected to earnings and profit planning. Cost management is strongly tied to the strategies used by the general management and its implementation modes.

In other words, we can define cost management as the process by which

enterprises use cost calculation for reporting or controlling cost variety of their ongoing activities.

As part of the traditional accounting system, the cost management has as its object of activity the collection, measurement, organization, analysis and transmission of information necessary for the enterprise management.

As part of an integrated system, the cost management also includes in its object of activity – apart from its management accounting functions – some economic functions, such as: planning, monitoring, analysis and cost control.

Starting from the above-mentioned ideas, we can extend the area of cost management and we can define it as the management system that uses cost calculation for a double purpose: on the one hand, for the collection, organization, analysis and cost control, and on the other hand, for drawing up and transmitting information as reports or dashboards necessary to the enterprise management for long or short-term decision making.

The management accounting represents the main tool that provides the cost management with accurate information for an efficient decision making. As shown in the definition of cost management, it also includes the provision of information necessary for drawing up and implementing an effective strategy in order to ensure a high level of quality, productivity and reliability at the lowest costs<sup>(1)</sup>. In another words, cost management represents an optimization process of both strategic and operational performances. The profitable business guaranty is given by the observation of cost management functions and the

fulfillment of the entire course of cost management ethos<sup>(2)</sup>.

The main functions of cost management as identified by the specialists are the following:

1. Cost planning consists in anticipating the resource necessary to an enterprise for the elaboration of cost budgets according to its organizational structure and the chosen management accounting method (responsibility centers, cost centers, processes, activities, products etc.). In the field literature, most managers have been opting for a transversal organizational structure that presents advantages clearly superior as compared to the hierarchical-functional structure (or classic structure).

The hierarchical-functional structure presents the following features:

- Activity is based on control. The hierarchical classic organizational structure is characterized by an authoritative management that exercises all the functions. Task distribution is based on orders.
- The organizational structure is centered on functions, whose information flow is mainly vertical.
- Attention is focused on internal problems.
- The organizational structure is rigid and stable. Compartmentalization is inflexible and is based exclusively on compartments and functional services. The gap between the top and the base of the organizational pyramid is wide, being made up of only a small number of operational compartments. The compartment branching – from an organizational structure point of view -

is very high on a vertical line.

In comparison with the classic structure, the transversal structure presents the following features:

- Activity is based on participation. The transversal organizational structure is characterized by a participative management, the manager collaborating with his subordinates. Task distribution is based on assignments.
- The organizational structure is centered on objectives, whose flow is horizontal.
- Attention is focalized on external influences.
- The organizational structure is flexible, change-oriented. The compartmentalization is flexible and it can be based on: activities, customers, products, functional services, etc. The distance between the top and the base of the organizational pyramid is small and is composed of both operational and functional compartments. The compartment branching – from an organizational structure point of view – is very high on a horizontal line.

The planning function of the cost management pre-supposes the correlation of all the enterprise budgets (supplying, production, sales, etc.) with the whole managerial process for analyzing and grounding decisions about practiced price policy, market and customer segments.

2. Cost evidence consists in expense and cost registration, according to their destination, considering the management accounting classification criteria.

3. Cost control consists of a comparison between effective costs and standards or pre-

calculated costs. Based on a pre-determined system, we can delimitate and analyze the deviation causes (especially the negatives ones!) that appear as a result of recorded differences between effective and planned activity. The accountant (from the management accounting department) plays the most important role, because he gets involved in planning and elaborating the strategy, according to the established objectives of the enterprise.

4. Communicating cost-related information. The information provided by the management accounting department must be clear, concise, simplified with respect to the informational content (reports, graphics, memos, etc.), so that its beneficiaries (other compartments or the enterprise management) should easily understand and use it in making adequate decisions. Management accounting department has the most important role in the information “act”. Knowing very well the duties of the other compartments, with which it communicates and cooperates efficiently, it also contributes to the information of the beneficiaries, thus demonstrating flexibility, in order to rapidly respond to changes occurred in the enterprise environment.

5. Reporting information through reports or dashboards. Dashboard represents a method of framing, selecting, arranging and presenting indicators that permit the visualization of a general tendency in the followed evolution. According to the objectives that he has established and follows, every manager can construct their own presentation of the dashboard, in line with the responsibilities established in the job description. The piloting dashboard has a double purpose: on the one

hand, it is used to select cost-related indicators and, on the other hand, to specify their evolution, thus constituting the fastest modality of generating actions for improving the enterprise performances.

6. The elaboration of cost-related strategy. The dashboards prepared by “the information manager” allow the enterprise management to respond rapidly to problems or unpredictable situations occurred during ongoing activity.

### **What is the ethos of cost management?**

The ethos of cost management represents the ensemble of standards and principles governing cost management. The specialists have identified the following principles:

#### **1. Defining clear performance objectives**

The essence of this principle consists in establishing and obtaining clear results, which are in accordance with the initially set performance objectives. The experience accumulated by most managers around the world and Romania, in particular, sums up only to “the reduction of costs” such as: salaries, lay offs, production rationalization, different budget-related expenses reduction in the enterprise. We can’t deny the fact that these actions undertaken by managers are not always useful.

For ensuring an efficient cost management, we must concentrate our attention on ensuring a discipline over all daily processes unfolding in an enterprise, which in turn yield an excess of employees and an extension of production lines, some of them unprofitable and non-value added. We should also consider justifying and implementing more efficient control systems. Cost management

represents the base of those systems and creates the need for such cost structures.

For example, in an industry where low costs are recorded, we can take as profitability bench-marks some pivot drivers or cost determinatives such as: production planning, efficiency maintenance, production diversity or technical knowledge (professional know-how). Each of these factors can constitute tools of cost efficiency or “causal base” for low costs values. The first step that must be taken for recording an efficient cost management is to understand the difference between a correct allocation of overheads, using scientifically determined cost drivers and an allocation of cost using arbitrary cost drivers.

As long as the established objectives are clearly and precisely formulated, results should match the expectations. By organizing an efficient marketing, by adding new products to the line already launched on the market and by applying thoroughly studied wrapping options or by extending distribution channels on different market categories, the revenues will be ensured and even increased, thus supporting the success and benefits projected through the company performance objectives in the cost management domain.

In order to guarantee an efficient cost management, the performance objectives must be aligned so as not to compensate for the achievements obtained from other processes at enterprise level by increasing the costs of other processes of the enterprise.

## **2. Providing tools and useful information for performance guaranty**

The use of terms such as “tool” and “useful information” in the context of performance is

related by the motivation of the employees involved in reaching it. If the enterprise management considers the fact that employees’ involvement in daily activities is shaped by the desire to best fulfill their duty, then the motivation and performances of the employees will be much higher.

If an enterprise wishes to achieve the optimum between production volume, production costs and revenues obtained as a result of production sale, then the personnel responsible for cost planning and profit making must possess sound knowledge about the following:

- the stages of manufacturing process within the enterprise;
- forecasting and establishing the standard (pre-calculated) costs of products;
- the impact that launching new products could have on the market segments;
- the decisions of customers about launching new products;
- the relevance of the fact that each of their actions affects customers, costs, inventory and production administration.

The same principle applies to cost management. For facilitating and ensuring the efficiency of cost control, managers should:

- know the specific cost drivers of their specific activities;
- understand the difference between efficiency and structural costs;
- understand the production and sale processes from a technical point of view;
- possess extensive knowledge about the daily activities taking place within the enterprise.

The more extensive the management’s knowledge about cost drivers of the enterprise

is, the higher the opportunity to have an efficient cost management to the detriment of cost reduction.

### **3. Understanding and accepting real production costs**

Standard cost represents the basic component of decision making, starting with budget preparing, real costs reporting and deviation determination and formulating strategies and performances based on concrete planning. The data obtained as a result of processing standard productions costs lead – in most cases – to establishing new sale prices, advertising, marketing and making complex decisions about the capital invested within the enterprise.

The importance of data obtained as a result of processing standard costs raises the problem of their accuracy. As we know, production cost is made up of material costs and direct personnel costs, plus the overhead rates. In the current environment, personnel costs include 10 per cent and material costs raise to 30 per cent of total production costs. The overheads represent only 50 to 60 percent of the total production costs. In this context in which overheads represent an important part of the total production cost, cost drivers are not related only to the production volume, but also to other factors.

The majority of managers suggest that most of these overheads (e.g. logistic costs, production, marketing, sales, distribution, service, technology, information resources and general administration) can be, in fact, traced down to individual products or product groups. Certain activities and processes consume an unbalanced quantity of these activities.

The majority of specialists argue that a wrong allocation of overheads can generate huge distortions in estimating production costs. Specifically, traditional cost strategies tend to assign more overheads to less complex products which are produced on a larger scale. On the other hand, overheads have been seriously underestimated the complexity of products and services manufactured on a smaller scale. Since this information cost is often used in the profitability evaluation of different production strategies, a wrong allocation of costs can cause managers to make wrong decisions. Understanding and accepting the need for real production costs has always represented a challenge for enterprise management.

It is extremely difficult to accept that information databases that underlay most decisions can be the negative root of many short-term business failures. This is especially true in the case of production costs and sale prices, but also in the case of justifying new products or their introduction. Until these cost distortions are known and adjusted, making managerial decisions at enterprise level (including the formulation of long-term strategies) remains extremely difficult to validate. Accepting reality is everything, but not for the majority of executive managers.

### **4. Setting excellence as performance target**

Constant improvement of enterprise performance is achieved by comparing past and present performances. At present, the focus is on establishing standards of excellence that should satisfy both customers' demands and the enterprise and management necessities.

The majority of enterprises chose for the services and products they offer for the following parameters: 100 per cent quality, zero delivery delays, zero damage during transport, gradual and annual reduction of production costs, regular development of skills and technical and technological knowledge of the employees – the so called know-how or professional savoir-faire. The alignment of the above-mentioned factors to the enterprise performances contribute in fact to an increase in performance culture and the behavioral ethos of cost management.

### **5. Reducing organizational complexity**

The enterprises with the most efficient cost management constantly apply clear tests of relevance and value for each of their daily unfolding activities. These tests are meant to question everything that happened in an enterprise during a regular work day or even over a management period.

The questionnaires are presented as question sets addressed to both department heads and to workers. Based upon the centralization of the formulated answers, solutions are searched for making cost management more efficient. A questionnaire like this includes questions such as: *How does this activity contribute to the creation, maintenance or even improvement of sales? What additional costs will be added for this activity? How does this investment contribute to quality improvement or flexibility in view of production growth?*

After centralizing these data, we will proceed to reduce non-value yielding activities and to stimulate the value-yielding ones, to

reduce organizational departments with a view to simplify unfolding processes, thus allowing for the fluidization of unfolding activities and for an increase in the inter-departmental and inter-processing communication (see the analogy between functional-hierarchical structure and transversal structure). The same target is pursued for the manufacturing line, which is submitted to similar tests. The products that are not profitable, cost-consuming and do not satisfy the customers' growing and constantly diversifying demands will be eliminated.

### **6. Involvement in reaching performances by knowledge**

In an enterprise we are often confronted by situations in which the employed personnel is not involved into more activities than it is specified by the job description, either by lack of interest or ignorance. As we know, access to a superior position is gained in time, by direct involvement, knowledge and respect. These two elements – knowledge and involvement – represent the key to success and excellence in the cost-efficiency relationship of costs.

As shown above, the five previously mentioned and explained principles of cost management efficiency are based on the fact that excellence depends on what the expert Edwards Deming called “profound knowledge”.

The ability to solve the problems that arise during unfolding activities and observing quality in the decision-making process represents the significant factors of staff involvement or their (mandate) empowerment. Only the employees that possess real, solid knowledge and indecision-making capacity

can ensure the success of the enterprise.

### **7. The impact of organization costs on management decisions**

The way we understand and accept the fact that most organizational costs are also structural represents the most important principle of cost management efficiency. This principle is based on two facts: first, we must accept costs and their yielding process, and second, that is management must accept the surrounding reality.

The first fact refers to costs that are generated with the help of department heads, approved by the management system through managerial decisions. These decisions concern both the number of products that are to be manufactured and the categories of customers they are addressed to, thus knowing and establishing cost drivers as well.

The second fact refers to the enterprise management's ability to accept changes through challenges related to past decisions in a flexible manner and the fact that most organizational costs have been created and sustained through previous managerial decisions.

The cost management efficiency is based on processes that lie within the culture of every

enterprise, representing a modality of continuing activity, of survival.

Those seven previously mentioned principles have been clearly emphasized by the specialists in the domain. What has been overlooked, in my opinion, is in fact the eighth principle, simply called "Strict compliance with all cost management functions", which is briefly presented below.

### **8. Strict compliance with all cost management functions**

By complying with all the above-mentioned principles and functions of cost management, we all can have the guaranty of a success at enterprise level. Making decisions by the enterprise management is achieved in time and correctly, acting in the shortest time possible and based on the dashboards. Respecting and performing cost management functions must proceed in strict accordance with cost management principles.

The ethos of cost management offers a real "image" over the application methods and understanding of cost management. Respecting cost management principles constitutes the way towards obtaining significant results that will influence the future decisions of the enterprise management.

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### **Notes**

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<sup>(1)</sup> It doesn't refer to "cost" in the cost reduction sense.

<sup>(2)</sup> Ensemble of standards and principles specific to cost management.

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