The Association of
Accountants and
Financial Professionals
in Business

# The Behavioral Aspects of Cost Management

Statement on Management Accounting

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IMA, the association of accountants and financial professionals in business, is one of the largest and most respected associations focused exclusively on advancing the management accounting profession. Globally, IMA supports the profession through research, the CMA® (Certified Management Accountant) program, continuing education, networking, and advocacy of the highest ethical business practices. IMA has a global network of more than 80,000 members in 140 countries and 300 professional and student chapters. Headquartered in Montvale, N.J., USA, IMA provides localized services through its four global regions: The Americas, Asia/Pacific, Europe, and Middle East/Africa. For more information about IMA, please visit **www.imanet.org.**

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# Executive Summary

Minimizing cost is a core aspect of organizational success. Management accountants are expected to play a central role in ensuring that all aspects of cost are effectively planned, controlled, and continually assessed for reduction. While effective planning and control systems must be developed and implemented, positive cost reduction results will be achieved only when there is a commitment on the part of all key stakeholders to take responsibility for cost management. Some organizations seem able to achieve this and remain competitive while others struggle.

This Statement on Management Accounting (SMA) focuses on the importance of organizational culture in developing a climate for effective cost management and builds on existing research on the importance of culture in effective financial control. Ultimately, costs are controlled by line managers and individuals who make effective day-to-day decisions that drive cost. To deliver on effective cost reduction, there must be the behavioral commitment as well as provision for and understanding of the necessary cost information. This SMA presents a cost aspects framework (the 5C's framework) that demonstrates the five core approaches of culture, care, communication, collaboration, and continuation that are required to support effective cost reduction.

Effective cost control is not achieved by short-term program approaches but by making frugality and cost containment a value that is integrated into the culture of the organization. This must start at the top and be reinforced by the behavior of every manager who demonstrates and encourages cost containment. Accounting plays a key role in providing cost information and aligning it to decision making. If the communication of this link is not effective, then understanding and cost control will fail. Many costs are process driven and expand beyond organizational silos, thus requiring collaboration between people internally and externally. Finally, the focus on cost containment and minimization must be constant and not become an imperative only when margins are tight. There is emerging behavioral research that indicates that the context within which a decision is made, such as those relative to cost, impacts the results; thus creating the right culture for management of cost is important.

While new systems, such as activity-based costing (ABC) and analytics, are required to collect and present information, a supporting culture is required to convert this type of cost data from insights into actions that improve cost performance. This SMA complements discussions on designing cost systems, cost maturity models, and approaches to costing such as ABC and target costing.[1] It describes the critical approaches to organizational behavior that make these systems deliver real benefits and, in particular, complements the SMA, *Values and Ethics: From Inception to Practices*, on integrating values and ethics into organizational culture.[2]

## A Brief History of Cost Management

Since the early days of management accounting, finance professionals have been seeking approaches to cost collection and reporting that add value to organizational decision making. The profession has been continually creating effective cost management solutions to mirror an organization's operational reality. Standard costing was conceived in the late 1800s and early 1900s, involving the work of George P. Harrison, G. Charter Harrison, and Alexander Hamilton Church, among others. It rose to prominence to reflect advances in industrial engineering when leading organizations, in particular General Motors under Alfred Sloan, adopted Frederick Winslow Taylor's approaches to scientific management, creating the foundation for the standard costing model.

Between the 1920s and 1970s, many organizations, particularly in mass-production manufacturing, adopted standard costing together with cost variance analysis to understand the differences between planned cost and actual cost. This formed the basis for decision making to keep cost performance in line and to identify and resolve problems. Yet in 1987, as pointed out in *Relevance Lost*, it was becoming clear that the usefulness of traditional approaches was declining and new approaches were needed.[3]

By the late 1970s and early 1980s, three key changes were taking place. First, global trade in mass-produced items—from electronics to cars—was becoming increasingly competitive, requiring a greater focus on understanding costs as well as quality and process management. Second, as manufacturers strove to respond to operational and cost challenges, automation increasingly replaced direct labor, thus decreasing traditional direct costs but often increasing indirect costs. Finally, as the manufacturing sector matured—especially in advanced economies—the service sector in areas such as financial services was growing, requiring more focus on indirect costs.

These changes led to myriad new approaches to operational and cost management from the 1990s until today, such as activity-based costing (ABC) and activity-based management (ABM) combined with an operational focus on process management, Six Sigma, lean accounting, Resource Consumption Accounting (RCA), Value-Based Management (VBM), throughput accounting, and others.

Organizations such as the Consortium of Advanced Management International (CAM-I), founded by the Department of Commerce in 1972, researched new approaches to operational management to respond to increasing competitive pressure (they also carried out initial work in areas such as budgeting and planning when they created the original Beyond Budgeting Round Table). During the same period, the International Federation of Accountants (IFAC) focused its research on the leading thought in the accounting profession in order to incorporate it into enhanced approaches to financial reporting and control, including costing.

In more recent years, as competitiveness increased and the role of management accountants became more important in supporting operational decision making, IFAC expanded its work through the

Professional Accountants in Business Committee (PAIB). This committee published two foundational pieces that underpin the journey of developing effective costing for decision making in the late 2000s.[4] IMA® (Institute of Management Accountants) and many other leading organizations in financial management were also active during this period in developing, researching, and publishing articles, papers, and other communications to demonstrate the value in new approaches to cost management.

As these new approaches to organizing, collecting, validating, analyzing, and reporting cost information were being applied, there was a constant discussion of why they worked effectively in some organizations yet failed to deliver the expected benefits in others. Management professionals started to research successful organizations, and gradually models in business excellence appeared in the United States and other countries around the world that helped identify the components of successful management.[5] Further research into these models reveals that, while each is unique, they all share common elements that include effectiveness in the following aspects:[6]

- Leadership;
- Planning;
- Client/market (customer, citizen) focus;
- Employee engagement;
- Partner (suppliers and other third parties) engagement;
- Process design, development, and execution; and
- Broad-based performance management and reporting systems.

In addition, most have a built-in requirement for a feedback loop designed to enable continual improvement in all aspects of planning and operational activity.

These models, together with research on the global best practices of organizations, began to reveal that success comes from a combination of effective approaches to the work that is done *combined with the creation of an effective culture* within which this operates—examples include Marriott, Toyota, Johnson & Johnson, and Proctor and Gamble.[7]

Task-oriented and relationship-oriented leadership have been understood since the 1940s. While tasks traditionally have been the focus, a growing body of research suggests that relationships are equally critical.[8] In particular, research into the success of The Toyota Way strongly supported these approaches.[9] Emerging research in the area of behavioral economics and how context impacts decision making is also relevant to discussions on effective approaches to cost management.[10]

Effective financial management and cost effectiveness need to reflect these transitions. New approaches, tools, and systems are required that reflect the changing nature of cost behavior, but these must be implemented with a culture that supports, encourages, and rewards stakeholder engagement in using the information. This can only occur in an organizational culture that balances task and relationship.

The Association of Chartered Certified Accountants (ACCA) has published extensive research that demonstrates the importance of corporate culture in effective financial management. One report, *Culture and Channelling Corporate Behaviour*, notes, "Functional behaviour contributes to the creation of long-term, sustainable value for the organisation, and the majority of its stakeholders."[11] (Note: ACCA and IMA maintain a partnership developing leading-edge research on the future of the profession).

## Scope of the SMA

This SMA provides a framework for cost control and reduction centered on organizational culture and individual behavior. The framework outlines how to incorporate the desired behaviors into the strategic foundation and values of an organization, and it is supported by five core components required to provide the required communication and understanding of cost information necessary to drive effective decision making.

This SMA does not discuss individual costing systems and approaches in detail, as there are many existing SMAs that provide a solid background in new tools, techniques, and systems for cost management.[12] In addition, the *Values and Ethics: From Inception to Practices* SMA contains information on building the culture required to underpin an effective framework for behaviors to drive cost management and reduction.[13]

## An Effective Framework for Cost Management

Senior financial leaders and others members of the C-suite must respond to the need for cost reduction, and in many cases the senior financial manager (the CFO or equivalent) leads the charge. But typically the CFO doesn't actually manage organizational costs. This is controlled by the actions and approaches of line managers and the people who work for them within an organization.

Thus, the CFO's success in implementing cost reduction can only come through influencing the action of others. While cost reduction programs may bring short-term relief from excess costs, they are not enough to sustain an organization's need to constantly focus in this area—in fact, at worst they become a constant "knee-jerk" reaction to gradually escalating costs or marketplace changes. Published articles and research have demonstrated that successful organizations have a number of aspects of effective cost management:[14]

- They are built within a *culture* where control and improvement of cost is an *embedded part of the organizational DNA*;
- They inspire and support *caring about cost* by encouraging ideas for improvement, sharing the benefits, and having an aversion to waste;
- They *communicate cost information effectively* by having appropriate costing tools and systems to track, monitor, and report costs;[15]

- They *encourage collaboration* through process thinking and cross-silo communication and cooperation; and
- They provide a *continual focus on cost improvement* that includes life-cycle thinking, continuous improvement, and avoidance of cost reduction as a program.

These five aspects form the foundation of the 5C's framework for effective cost management.

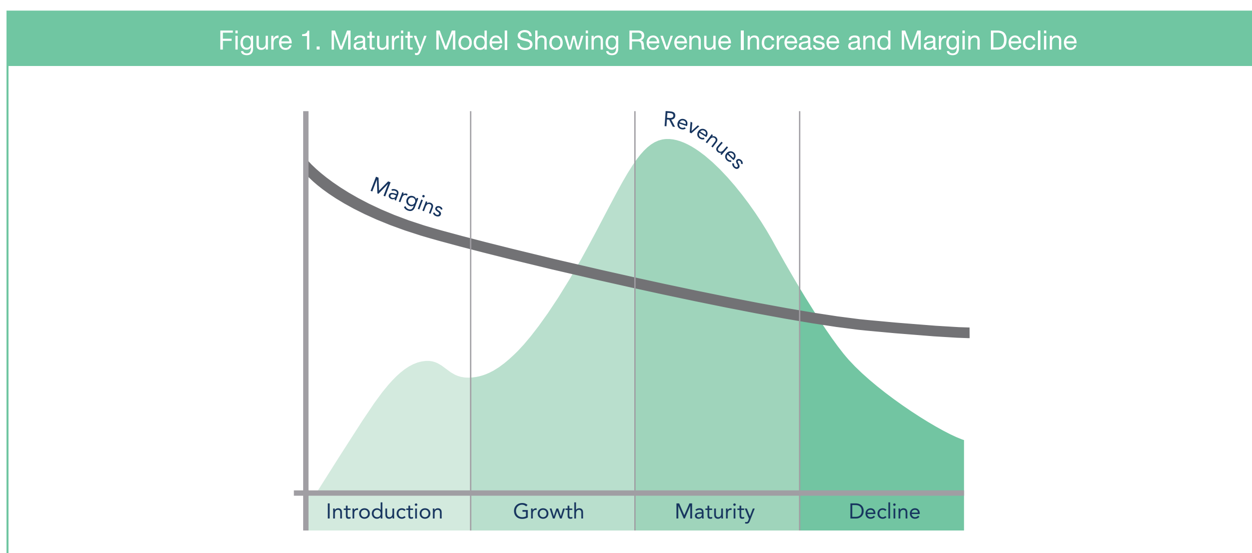
## THE GOAL OF EFFECTIVE COST MANAGEMENT AND CONTROL

The overall goal for cost management is competitive survival. Governments managing costs effectively can allocate scarce resources to the most pressing needs and keep tax rates low for their jurisdiction, thus contributing to national competitiveness. Not-for-profit organizations can apply their limited resources to providing a broader range of services together with greater reach, quality, and sustainability. In the for-profit sector, cost control is central to ensuring adequate levels of profitability while offering competitive features and pricing on products and services. This has to be achieved within the realities of the competitive supply chain and marketplace costs of resources—labor costs, benefit costs, supplier costs, and other costs.

Models of economic theory suggest that the price for new products in a free marketplace can be set by the seller. But as competition enters the market and supply increases, prices are eventually driven down; unless costs are reduced, this results in declining margins and profits. The BCG (Boston Consulting Group) Portfolio Planning Model demonstrates this life-cycle approach.[16]

For organizations to remain competitive, this cycle of innovation—including product enhancement and new product release—is typically perpetual. Therefore, it follows that cost control and reduction must be a constant focus rather than project-based initiative. Figure 1 illustrates this by overlaying the traditional

Figure 1. Maturity Model Showing Revenue Increase and Margin Decline



growth and decline revenue maturity model with a depiction of profit margin behavior during the same cycle.

Traditionally, this model applied to the direct costs of a product. Improved understanding of cost behavior, however, has demonstrated that a product's indirect costs are increasing relative to its direct costs as differentiation and variation of products expand (for example, more colors, sizes, and ranges). This causes higher product-related indirect costs incurred from the increased complexity to support processes that deliver outcomes. Nonproduct costs in distribution, selling, marketing, customer service, and accounting also need to be calculated to report and analyze both channel and customer profitability below the product gross profit margin line.[17] Examples include the need to reduce the costs per accounts payable invoice paid, the costs per sales call, and the sales cost per dollar of revenue. Thus, a constant understanding and reduction of the cost of production and services of every aspect of an organization's activity is equally important to sustain a competitive advantage.

While many organizations seek to achieve these reductions by outsourcing the complete function, this merely moves the burden of cost reduction to a third party rather than retaining it within the organization. Supplier cost reductions therefore also become critical to continual competitive advantage.

## THE CHANGING FOCUS FOR COST MANAGEMENT

While the goals of reducing cost have remained constant, the areas of focus for achieving this have shifted. In manufacturing organizations, direct materials and direct labor have been well understood for a long time. Continual effort to drive down labor costs through automation, simplification, the elimination of tasks, and other process improvements has delivered considerable benefits. When the only opportunity left to reduce labor cost is the hourly rate, the solution has become outsourcing to lower-cost environments, which could be offshoring or, in the U.S., right-to-work states without unions. Traditional approaches to reduce incoming materials costs have included competitive bidding between suppliers and changing suppliers when lower-cost opportunities arise. Again, in many cases, this has involved buying offshore at lower costs, reducing unit costs, and adding some level of transportation.

Indirect costs in many organizations have typically been controlled by responsibility centers—attributing costs to cost centers controlled by managers and tracking costs by expense type. Reductions were typically achieved by a constant focus on headcount reductions and the stringent control of expenses.

As direct costs are driven down and/or outsourced, a larger portion of costs become the result of supplier negotiations rather than internal control creating a higher level of interdependency between buyer and seller. As direct costs are reduced overall, the indirect costs become a larger portion of the cost base. Efforts to reduce costs through headcount reductions often produce dysfunctional outcomes as individual manager's drive their own costs down but create negative impacts elsewhere within an organization. This impact of silo management has been recognized as causing problems since many internal processes cross organizational boundaries, i.e., silos.[18] Also, operational activity through

processes is highly interdependent, and cost reductions in one area create operational problems and cost pressures for other areas. Finally, in any area of work that touches the client or customer, efforts to reduce across-the-board cuts generally result in declining operational capability, client service, and reputation. This can be seen in marketing, sales, engineering and design, accounting, human resources, information technology, and other areas. It decreases the capability—and thus the intangible (goodwill) value—of an organization.

As the architecture of an organization's activity changes, the approaches to planning, controlling, managing, reporting, and reducing costs must also change.

### The Shift to Intangibles

Another major underlying shift has been taking place for more than 30 years.[19] Organizational value has shifted from approximately 80% book value and 20% intangible to the opposite, where 80% of an organization's value is now attributed to value not represented on the balance sheet.

The content of this intangible value typically includes human, structural, and relationship capital. More specifically, it represents the capability of the organization to deliver results through its people; processes; leadership; brand; reputation; relationships with suppliers, customers, distributors, regulators, and others; and employees' capability to innovate.[20] Table 1 provides an example, presenting the values in thousands for Apple, Google, and Coca-Cola as of December 2014. It includes their market values, brand values as determined by Interbrand and Brand Finance, and book values. The Other Intangibles column is determined using the lesser of Interbrand's or Brand Finance's estimate, and that result is then used in the Book %, which represents the book value as a percentage of the total market value.

Most of these capabilities are created through the efforts of the people in the organization, their ability to work together effectively across organizational silos and with key third parties, and the relationships that are built to make this possible. This combination of capabilities can be defined as the culture of the organization. The value attributed to these intangible assets can be substantially depleted through cost-cutting approaches across the board that damage the capability of these intangibles and destroy the organizational culture.

Table 1. Examples of Value, Brand, and Intangibles (in $M)

| | Market Value | Brand Value 2014 | | Book Value | Other Intangibles | Book % |
|---|---|---|---|---|---|---|
| A | B | C | D | E | F | G |
| | | Interbrand | Brand Finance | | | |
| Apple | $643,120 | $98,316 | (*$104,686*) | $124,183 | $420,621 | 19% |
| Google | $355,000 | (*$93,291*) | $68,620 | $96,000 | $190,380 | 27% |
| Coca-Cola | $184,930 | (*$79,213*) | $33,722 | $30,321 | $120,887 | 16% |

While cost cutting and continual improvement are important keys for organizations, the approach must be surgical and targeted to ensure not to deplete the intangible aspects that provide organizational capability and capacity.

### Optimizing Organizational Value

Organizational value is typically determined by looking at the company's balance sheet value as well as its capacity to generate earnings and cash flow and to pay dividends to investors. The role of management is typically to protect and grow this value for the benefit of the shareholders. This is a particularly important role in private companies, where the value of the business may form the basis of the owner's principle assets that would be sold upon retirement.

Traditional earnings reporting shows that managers can achieve cost reduction in the short term, but this often depletes organizational value over time. But that loss of value does not show up until a later date when earnings begin to drop because the intangibles within the organization begin to lose their capability to collaborate and cooperate effectively. By the time this happens, short-term bonuses have often been earned and paid out, and often leaders have moved on to other opportunities, leaving their successors with a legacy of depletion and a need to rebuild capacity. This, in turn, can deplete earnings further as it becomes necessary to invest in intangibles again. The critical challenge for effective managers is to control costs in a way that does not deplete this intangible value.

Nowhere is this issue demonstrated more clearly than in mergers and acquisitions. Various books and analyses have placed the failure rate of mergers and acquisitions between 50% and 80%.[21] The rationale for conducting a merger or acquisition is often the thinking that the combination of the two companies would bring greater opportunities and higher earnings. In many cases, part of the justification is the potential of lower costs with a merged entity. Many M&A failures can be tracked back to the loss of value created by the efforts to integrate two organizations, especially in the area of combining operations to reduce costs. Where approaches are not surgical and result in depleting value, the ultimate impact is an impairment or even elimination of goodwill and a write-off against earnings.

To *optimize organizational value* is to view an organization as a "system" where it is the interaction of the sum of the parts that creates capacity and capability to drive value. If approaches to cost cutting are not holistic and do not recognize the interdependencies of the individual parts of the system, the overall value will be depleted.

### Operational Capability, Intangibles, and Cost Control

The past 30 years have seen the development of core aspects of operational capability that are essential to value creation. Organizations can be simplistically represented as entities that have inputs, processing capabilities, and outputs. Suppliers and supply chains focus on inputs. Process management and asset utilization are the focus of processing capability, and outputs are those results that deliver outcomes.

In the private sector, the goal is to provide products and services that satisfy clients, and, in the public sector, the goal is to meet the needs of the citizens. All these aspects drive the capability and capacity of the organization to operate, but they also drive costs.

Approaches to inputs through purchasing and supplier relationships have changed significantly. Value is built through effective supply chain relationships that promote innovation and creativity, thus capitalizing on the contributions from both the buyer and seller—who share in the benefits. Traditional approaches to cost cutting, such as mandated price reductions, can alienate suppliers and erode the value created in an effective interdependent supply chain.

Furthermore, it has long been estimated that, after eliminating purchased costs, 75% to 90% of the remaining organizational cost is created through the execution of processes. (This is the foundation for the need for ABM and ABC.) As stated earlier, the processes associated with direct costs that drive labor are well understood, but they are becoming a smaller portion of overall cost. The impact of indirect-cost processes is often less understood yet constitutes a growing portion of overall cost. These processes underpin and enable the capability of the direct-cost areas to execute their work effectively. Examples are the purchasing processes, hiring processes, engineering and technical support, and areas such as order desks and call centers.

Since most of these processes cross organizational boundaries (or silos) during execution, they require a high degree of interaction. If processes are interlinked from end to end while costs are managed by silo, then across-the-board cost cutting such as headcount reductions runs a high risk of disrupting the operational effectiveness of parts of the process. At worst, they serve to build the walls around each silo as managers protect their own resources. Communication, collaboration, and cooperation are reduced, resulting in less effective processes on a cost-per-transaction basis along with slower execution and less innovation. In short, traditional approaches to cost reduction can rapidly deplete organizational capability and value.

Another aspect that drives intangible value for organizations in today's global competition is how they build a customer-focused capacity. This entails marketplace knowledge, engaged clients, responsiveness to problems and issues, continued price competitiveness, high quality, and breadth of availability and delivery channels. While the customer list may have some level of intangible value, the value created through the interactions between the seller and the buyer has even more value as an organizational asset. As the seller and the buyer continue to interact, their shared knowledge about areas such as the cost of changing suppliers will grow. Traditional approaches to cost cutting can often damage these relationships, which have taken time to develop.

Next, as intellectual capital and knowledge management create and sustain value, they are becoming more important, impacting people management in all environments. Motivated employees typically demonstrate a higher level of collaboration, communication, and cooperation as well as a greater

commitment to their work and the goals of the organization. People are core drivers in the creation of most intangible value. They develop and improve processes. They innovate. They work together to create a responsive entity. They are willing to implement change as they feel less threatened by job loss and often accept the risk of reassignment and training opportunities. As speed and innovation have become greater core competitive advantages, the need for engaged and motivated employees is increasingly critical. This is a foundational issue that can only be addressed by sustaining a culture that recognizes the impact that change has on people and that provides approaches and structures to fully engage and involve employees through periods of change. The great impact this issue has on the training of managers in leadership skills cannot be understated.

Approaches to cost cutting that exclude the engagement and involvement of employees can have a major impact on the levels of motivation. People do not react well to having things done to them. They are typically more willing to address the challenges and issues when they trust managers and are engaged in the discussions about the change. Thus, top-down, across-the-board cost cutting creates significant negative impact on both organizational value as well as its ongoing capacity to remain competitive.

Finally, surviving manufacturing organizations are often highly automated. Processes are interlinked directly to suppliers and inputs using and applying systems such as Just-in-Time (JIT) delivery sequenced direct to the line, continual processes through all stages of production, flexibility in applying variable production (flex manufacturing), and integration with shipping organizations and intermediate or ultimate clients. This automation has brought about the need to look upon the organization as a system where all parts must function or the whole system shuts down.

It has again become necessary for a high level of cooperation and interdependency to exist between the human parts of the system in order to optimize return on investment. Silo management and turf protection to protect the budget will be highly detrimental in this reality. Cost cutting must again be carried out surgically, recognizing the interdependence of the parts. While some areas may have the opportunity for major reductions, others may require sustained or even increased funding to optimize the system. Much of this thinking was at the heart of the capacity management and optimization work of Eli Goldratt, who promoted the opportunity available to organizations that focus on the system aspect of maximizing performance.[22] It is also a core component of successful organizations (like Toyota) that focus on the overall performance of the entity and recognize high levels of interdependency between the parts.

### Relationships and Cost Control

For many organizations, especially those in services such as banking, insurance, and others, total labor costs continue to present the highest single number in their operating expenses, and there is a constant focus on opportunities to reduce these costs because they can provide the biggest impact to an improved bottom line.

An organization's culture creates the foundations of how relationships are built. Many successful organizations, such as Johnson & Johnson, have developed stated values that guide the behavior through which relationships are developed.[23] Typically, the foundations of effective relationships are trust, mutual respect, awareness, diversity, and communications.[24] These values are not built rapidly. They evolve over time.

Competitive advantage, and thus organizational value, comes from relationships in many areas, such as those between:

- shareholders, the board of directors, and management;
- leaders, managers, and other employees;
- employees in different areas, departments, countries, regions, and divisions;
- suppliers and the organization;
- distributors and sellers;
- customers, clients, and organizational staff, including sales, service, administration, design, and others; and
- other stakeholders, such as the community in which the business operates, local governments, and regulators.

Cost-cutting approaches can damage relationships—externally, internally, and with the customer. Examples of short-term efforts to reduce supplier costs include threatening suppliers or changing suppliers (a strategy that was prevalent in organizations such as GM in the past), making changes without communications, or not honoring contracts (for example, not abiding by negotiated payment terms). Internal relationships can be damaged by cutting back on the orientation and training of leaders, not treating employees fairly, failing to communicate changes that will impact employees, and not having recognition and reward systems that share savings with employees. Client relationships can be significantly impacted by approaches in cost savings such as slowing down credits and returns, cutting back on call center capability and responsiveness, reductions in service staff availability, changes in the value proposition through unilateral changes to terms of supply or service to save money, and many others.

None of these points should be construed as making a case for not reducing cost. The task remains the same—to reduce cost. But the ways in which people interact in business relationships have the greatest impact on organizational capacity and value.

### Organizations and Strategic Sustainability

Shareholders need to understand both current performance and the risk involved to ensure they are investing wisely for the future. In a public organization's annual report, the management discussion and analysis (MD&A), or the management letter, provides an overview of the organization's past performance and identifies key aspects of its ability to operate in the future. Auditors are also required to perform a

going-concern verification to assess the ongoing viability of the organization. Both these requirements address the organization's financial ability to remain a going concern into the future.

For organizations with high levels of intangible assets, it is more difficult to assess the capacity to operate in the future. While the discussion of reporting and performance indicators to provide this visibility are outside the scope of this SMA, financial managers need to be aware of the impact of the drivers of sustainability, particularly from intangibles. Financial managers also need to have ways of assessing whether the capacity of these drivers is being depleted, sustained, or enhanced by management actions, particularly when implementing approaches to cost management.

Taking action to reduce costs in ways that are not targeted can damage the capacity of intangible assets to operate effectively. This can diminish and possibly destroy the organization's competitive advantage and future sustainability. Reliance on traditional financial reporting will only reveal the problems by looking at past history. But by the time revenues and margins decline, it is too late.

## The 5C's Framework for Effective Cost Management

Financial managers need to adopt a holistic approach to cost control and reduction. This requires equal attention to the tools, methods, and techniques being selected (as suggested in the IMA's SMA, *The Conceptual Framework for Managerial Costing*), as well as certainty that the culture supports a focus on cost.[25]

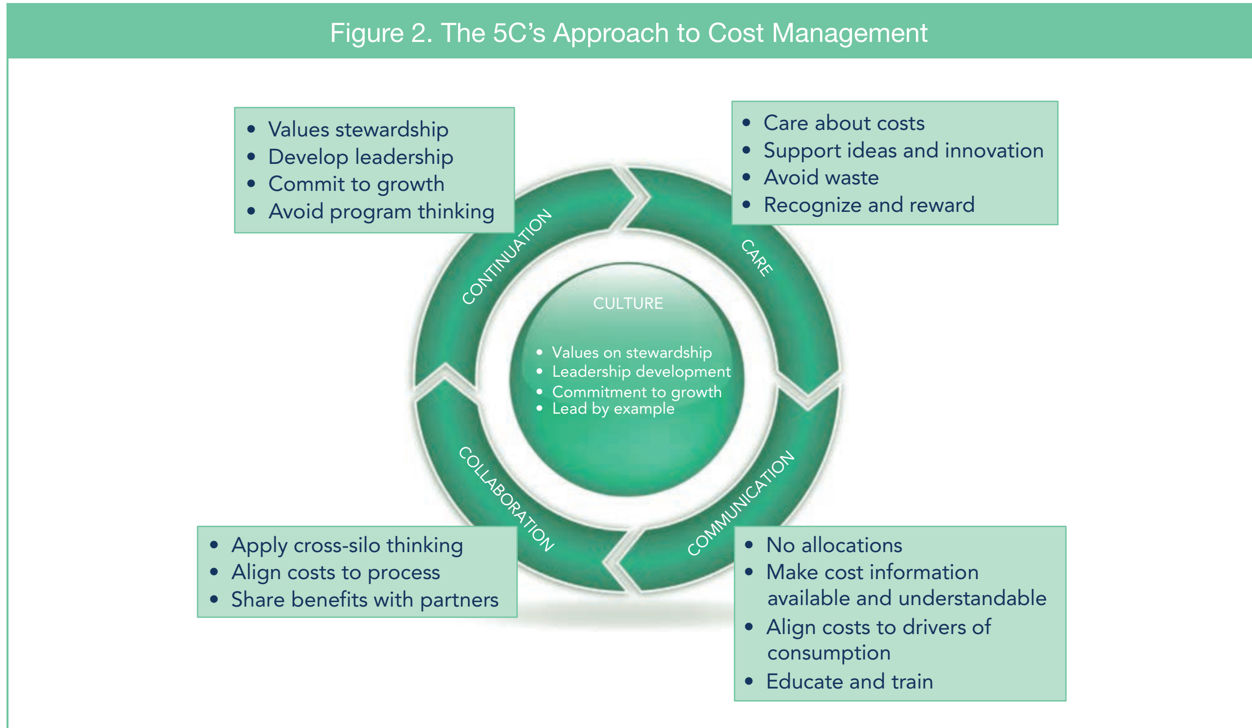
Figure 2 shows the 5C's framework for a holistic approach to cost reduction: culture, care, communication, collaboration, and continuation. The central foundation is the organizational culture, supported by the other four C's. Although finance executives do not control the culture alone, they do sit at the senior management table and work with their peers to influence decision making.[26] It is in this role that they must establish a broad understanding about the effectiveness of cost control as an organizational issue.

Finance executive can create systems, implement controls, provide information, and offer guidance and advice, but ultimately the role of cost control permeates every activity within the organization. For this reason, effective cost control must reflect this and be embedded into the culture or DNA of the organization.[27] Finance executives have direct responsibilities in key areas of this framework and a critical need to influence the others. We move now to discuss each aspect in more detail, starting with ensuring that culture is integrated to strategy.

### THE STRATEGIC APPROACH TO A COST-EFFECTIVE CULTURE

At the heart of effective cost control and continual reduction must be a culture that supports and enables the required actions and decision making. This can only be achieved at the strategy level where the

Figure 2. The 5C's Approach to Cost Management




organization's mission (which drives the desired outcomes) and values (which drive the desired behaviors) are both embedded. Many organizations profess to have a set of values, but it is extremely hard for these to become a solid part of culture and behavior.[28]

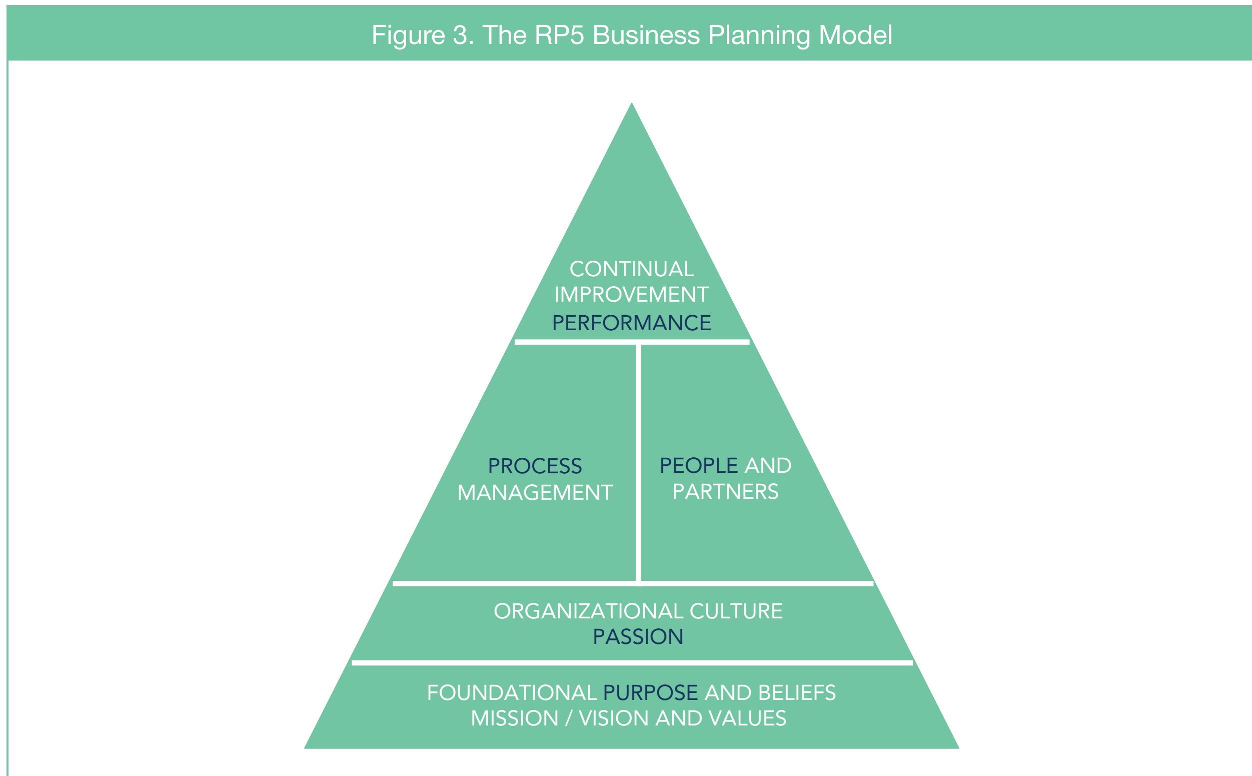
Financial managers need to ask two questions to determine whether the required cultural foundation is in place:

1. To what degree are organizational values stated, considered, and embedded in the frameworks for business planning?
2. How effectively are desired behaviors being deployed in practice through areas such as hiring practices, leadership development, performance reviews, and process and policy alignment?

Employee surveys and other feedback will help determine the level to which stated expectations of behavior, based on values, are being reflected in day-to-day operational decision making.

There are many approaches to business planning frameworks, and each organization will have its own. Figure 3, known as the RP5 Business Planning Model, reflects the core components of the type of organizational planning framework and approach required.[29]

Figure 3. The RP5 Business Planning Model




The foundational culture must create a base for both task (the stated mission and process) and behavior (relevant to building relationships and the foundation for many intangibles and values).

Leadership development and consistency of management action are required for the effective application of the underlying business planning framework. Once the organization has established its strategic planning and direction (the foundation of outcomes and tasks) and its approach to behavior (through organizational values, code of conduct, or the equivalent), the responsibility for implementing and reinforcing it across the organization becomes the responsibility of every manager responsible for people, resources, and all aspects of relationships.

The financial executive's principle responsibility is to ensure that adequate attention is being paid to these aspects and that an effective approach to training and developing staff in leadership positions is in place. In addition, expectations of behavior that underlie all other effective relationships must be applied when working with key partners such as suppliers.

## ALIGNING COST MANAGEMENT WITH CULTURE

The financial executive should ensure that each aspect of the planning framework is complemented by an aspect of cost management (see Table 2). Each of these linkages is explained in detail in the following sections, and each links to the core components of the business planning framework used as an example.

Table 2. Aligning Strategic Planning and the 5C's

| Business Planning Framework | Cost Elements | Explanation of Financial Aspects |
|---|---|---|
| Purpose | Culture | The foundational approach to planning and running the enterprise—a combination of task (mission) and relationship values that guide behavior |
| Passion | Caring | Building the culture—engaging the resources required to convert intent to action in a way that reflects care about cost minimization |
| Process | Communication | Alignment of business process and resource allocation to execution of task and clarity of communication of costs aspects and impacts to decision makers |
| People | Collaboration | Aligning values with human engagement, often through processes and partnerships, by converting "intent" into action through effective collaboration and coordination |
| Performance | Continuity | Approaches to sustaining cost improvement as a core strategy through continual improvement and cost "life cycle" thinking |

At the center of the cost framework is the underlying culture of the organization. This is closely followed by care—caring about costs builds the underlying commitment to make effective cost control a permanent area of focus within the culture. Next, the communication aspect focuses on the provision of information about cost behavior and results. Then the collaboration aspect is in place because a great deal of cost behavior spans departments or silos—and effective cost behavior management requires proper interaction among them. Finally, the continuity aspect is needed to avoid the on-again, off-again approach to cost. To some degree, this aspect borrows from the thinking of the W. Edwards Deming, whose 14 points for sustainable quality management addressed the need for a permanent, nonprogrammatic approach to quality management in order to make it a way of life.[30]

## THE CORE: CREATING A FOUNDATIONAL CULTURE

Creating a culture that includes and embeds cost management is a primary goal, but it is the foundational direction and values under which the organization operates that can make it happen. Table 3 illustrates the types of high-level foundational approaches upon which effective cost management can be built.

Financial executives have a number of responsibilities for communicating the concepts of value and for ensuring that culture is more than just words. First, they must play a key role in getting shareholders and owners to understand the impact that intangibles have on organizational value and continuity. This complements the strategic inclusion of behavioral aspects in the business planning framework.

Without this understanding, there will be no recognition of the risks associated with cost cutting methods that can negatively impact organizational value as well as deplete the intangibles that underpin the value and sustain the organization's capacity to operate. Given that these represent on average 80% of corporate value, this *must* be a foundational concern and understanding for those who set overall

Table 3. Core Actions for Developing Culture

| Aspect | Finance's Responsibility | Finance's Influence |
|---|---|---|
| Ensuring concept of value and intangibles is understood | √ | √ |
| Communicating with and ensuring that owners/shareholders understand risk related of intangibles and impact on sustainability | | √ |
| Ensuring a clear, sustained statement of mission and values | | √ |
| Ensuring that goals and KPIs include task (outcomes) and relationship (behaviors) | √ | √ |
| Ensuring alignment of policies and procedures with stated values | √ | √ |
| Ensuring investment in leadership development of all managers | √ | √ |
| Avoiding short-term financial guidance | √ | √ |

organizational direction and goals. Profit and performance goals and objectives must be developed in an atmosphere that takes this into account. Finance has a core role in understanding and communicating this issue.

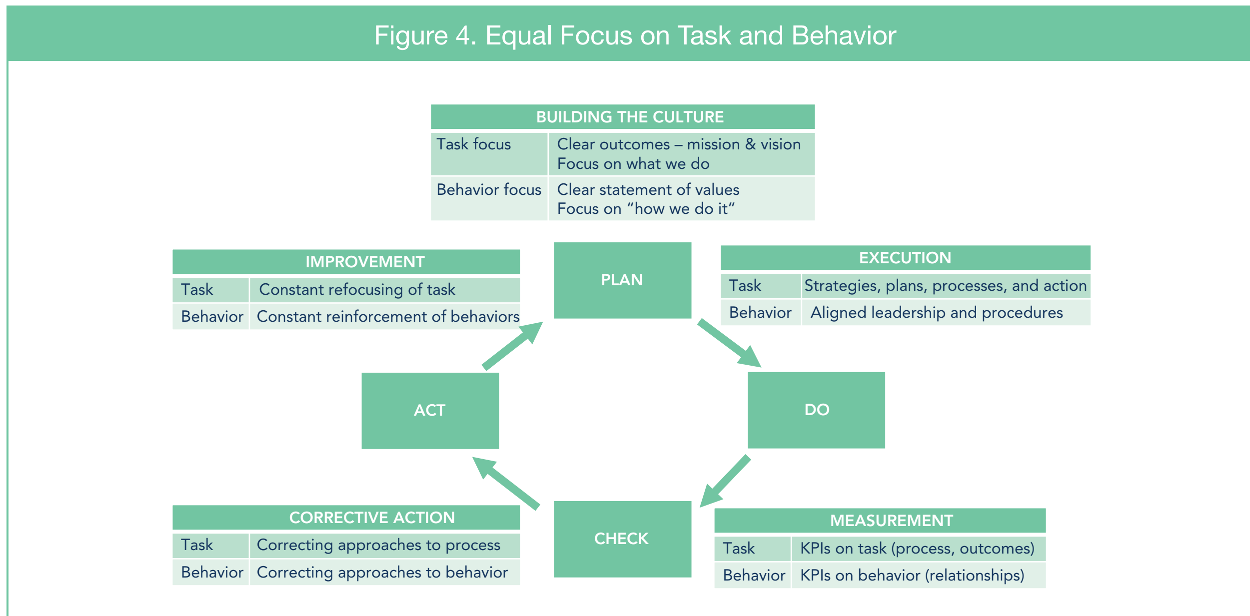
Second, finance must help and even champion strategic approaches to the redeployment of resources. Investment continuity is not about guarantees for the future—this is unrealistic. Rather it is about commitment to the continuity of the organization. This is important because it creates the base for continual redeployment of resources. This approach must involve seeking growth opportunities in the existing business as well as new ventures rather than one of scarcity that minimizes reinvestment. After all, no business can shrink to greatness, and if all savings result in employees being terminated, there will be little motivation to seek opportunities for improvement.

Third, finance must strive to ensure that strategic commitments to both the mission and the values that drive behavior become an operational reality. Most organizations have vision and mission statements that focus on the outcomes for the owners, shareholders, or others. These must be in place in order to align the resources that will be required to actually create the desired outcomes. Many organizations also have statements of corporate values, but they often are not deployed well and fail to build the desired culture. Organizational planning often focuses principally on outcomes and less on the behavior expected to achieve these outcomes. While this thinking about alignment is not new, it continues to be a challenge for many organizations, especially in the behavioral aspect.[31]

Figure 4 overlays Deming's Plan-Do-Check-Act (PDCA) model with the traditional approach that focuses equally on task and behavior.[32] This demonstrates how effective deployment of both mission and values can be achieved.

This link between organizational culture and effective financial performance is not a new concept.[33] Many successful organizations, such as Coca-Cola, TNT, and Johnson & Johnson (J&J), have clearly stated values in place. J&J created its ethics credo in 1943. To this day, it still influences everything the

Figure 4. Equal Focus on Task and Behavior




company does and how it is done. The company's actions during the Tylenol tampering incident, for example, demonstrate the link between decision making and sustaining corporate values.[34] Along with the business examples, research work on behavioral economics also shows a connection between the rationality of decision making and the context or culture within which it takes place.[35]

The financial manager also must ensure that organizational key performance indicators (KPIs) include performance relative to tangibles as well as intangibles.[36] For example, if the owners or senior management have no KPIs relative to relationships with key stakeholders (such as employees, suppliers, or others), they will remain unaware in situations where operational activities to reduce cost begin to impact the values of intangibles. Value might be depleted and only noticed after the event when sales revenues and customer retention decline. By then, it is too late.

Many organizations have started to recognize the challenges created by the marketplace in issuing short-term financial guidance. For many, this "setting of expectations" drives behavior centered around short-term results rather than long-term value. Several successful organizations have ceased this practice, and, in many cases, the market has not penalized the decision.[37] A willingness to accept this must start at the ownership and board level and should be encouraged and championed by the financial manager.

## CARING ABOUT COST AND BUILDING ON THE CULTURE

Once the cultural foundation has been set in place, the second aspect is to create an attitude of caring about cost as part of the passion that underpins the organization's activities (see Table 4). Again, this must become part of the culture—the foundation of which is set at the purpose and planning stage.

Table 4. Developing a "Caring About Cost" Approach

| Aspect | Finance's Responsibility | Finance's Influence |
|---|---|---|
| A. Aligned, trained, and effective leadership at all levels | √ | √ |
| B. Culture of engagement in planning | √ | √ |
| C. Inclusive organizational structure—limited hierarchy | | √ |
| D. Control systems that enable the work of the business | √ | |
| E. Effective compensation, and reward and recognition systems | | √ |
| F. Operating procedure alignment | | √ |
| G. Performance rewards that address tasks and relationships | | √ |

*A. Aligned, trained, and effective leadership at all levels*

"Living the culture" starts at the top in the same way that risk management and the attitude toward controls starts with leadership.[38] If members of the C-suite do not seem to worry about cost, then this attitude will become pervasive across the organization. To make this real, all senior leaders must create an underlying foundation of trust with employees and others. While ethical behavior is a key part of this, other factors that contribute to building trust include having confidence in subordinates and avoiding micromanagement, inclusion in planning, sharing in decision making wherever possible, and developing personal connections.[39]

Those in leadership positions must buy in to the behavioral values of the organization. They ultimately will bring those values to life in the ways that they interact with others and, over time, build credibility and trust. Finance must both influence and support this concept. Financial commitments to the development of people must be a permanent part of resource allocation. Yet for many financial managers, the cost of training is the first item to be eliminated from the budget.

*B. Culture of engagement in planning*

Initiatives for effective cost reduction often drive organizational changes ranging from how work is done to overall accountabilities and responsibility. An effective organization is managed to operate in a state of change readiness so that change can occur on a continual basis. This willingness can only come from involving and engaging both internal and external stakeholders. Leaders create the climate for this and put the processes in place to allow it to happen.

Finance must play a key role in ensuring that, in the approach to planning, staff as well as suppliers, distributors, and other key stakeholders are engaged in the process. This happens at two levels: first, providing input on the current reality and understanding how priorities are developed and decisions are made; and second, being fully engaged in the decision-making process to determine how to convert plans into actions. Managers who "tell staff what to do" destroy any culture of trust, engagement, and

commitment. In addition, it is much easier to deny responsibility for results if the plans and actions required no commitment. Finally, finance is often caught in the trap of changing the numbers when business plans do not deliver the expected results. This disconnects ownership from resources and allows line managers to avoid accountability.

*C. Inclusive organizational structure—limited hierarchy*

How an organization is structured impacts people's willingness to believe in cost reduction and delivers the message that the entity is "lean and mean!" Eliminating unnecessary roles and levels of management reinforces management's message that waste will not be tolerated. Removing barriers between all levels is important so that ideas are free to flow quickly and openly. Delegation of authority should be decentralized to the maximum degree possible, and front-line employees should be empowered to make decisions that impact their work. Finance must be in alignment with this concept since the segregation of duties and other internal controls can quickly create barriers to effective actions that could have reduced costs.

*D. Control systems that enable the work of the business*

Finance must also take the lead in evaluating corporate risk and controls to ensure that the organization is "just in control." Excessive controls can inhibit the innovation and creativity needed to stimulate ideas that improve operational effectiveness. Excessive costs are often incurred and sometimes go unnoticed when front-line staff develops ways of getting around excessive controls. Maintenance staffs are often unfairly accused of hiding spare parts and inventories, but this is due to the requisitioning and purchasing policies that slow down the purchase of parts needed for repair of equipment—and thus negatively impacting capacity utilization and equipment uptime. Ultimately, ineffective purchasing policies drive up the overall cost of business by encouraging actions such as Just-in-Case (JIC) inventory management. In addition, the search for the lowest bidder often drives up administration costs that eat away at unit cost savings through higher process costs in areas such as purchasing, receiving, inventory management, and payables. Duplication of generic interchangeable parts can also occur when inventories are managed by vendor part number and when purchasing constantly changes vendors, resulting in higher inventory and often unplanned obsolescence.

*E. Effective compensation and reward and recognition systems*

Finance must be engaged and involved in the development of reward and recognition systems that are structured to ensure employees can see that the basic compensation plans are fair relative to both competition and their own performance, including the sharing of savings from cost reduction initiatives. For example, a North American global automotive parts company established fairness of compensation and profit sharing as a core component in its employee's charter.[40] It was put into place when the company was new 50 years ago. Since then, the company has grown to become a global multibillion dollar corporation and has been able to remain competitive in a fiercely cost-competitive environment.

*F. Operating procedure alignment*

Purchasing and accounts payable are areas where stated values are often ignored. If an organization states that it seeks to develop collaborative and cooperative relationships with its suppliers but then fails to involve suppliers in business plans, threatens the supplier, and fails to honor contractual obligations (such as 30-day payment terms), then it is not operating in good faith and is not building the basis for an effective partnership. An example of living the values is demonstrated in how Toyota partnered with its suppliers in the 2008-2010 automotive downturn.[41] The company paid suppliers upfront, adjusting purchases of tooling to help suppliers' cash flow and even stockpiling parts inventories to help suppliers' cash flow problems.

*G. Performance awards that address tasks and relationships*

Organizations tend to get the behavior that they reward. Behavior is impacted by performance appraisals that managers and staff receive. For many years, managers have been awarded bonuses based principally on the delivery of outcomes—in other words, achieving the tasks required. Consideration of *how* the tasks achieved is often neglected. The following statement from the GE 2000 Annual Report shows how GE adjusted its bonus plans to more effectively align values and performance:[42]

> And it's about the four "types" that represent the way we evaluate and deal with our existing leaders. Type I: shares our values; makes the numbers—sky's the limit! Type II: doesn't share the values; doesn't make the numbers—gone. Type III: shares the values; misses the numbers—typically, another chance or two.
>
> None of these three are tough calls, but Type IV is the toughest call of all: the manager who doesn't share the values, but delivers the numbers; the "go-to" manager, the hammer, who delivers the bacon but does it on the backs of people, often "kissing up and kicking down" during the process. This type is the toughest to part with because organizations always want to deliver—it's in the blood—and to let someone go who gets the job done is yet another unnatural act. But we have to remove these Type IVs because *they have the power, by themselves, to destroy the open, informal, trust-based culture we need to win today and tomorrow* (emphasis added).

The ability to care about anything, including cost within an organization, is a direct reflection of the engagement of employees and other partners. To have this within the organization, leaders must create a passion about what they do, both in terms of mission (the content and deliverables) as well as values (how they behave to achieve the goals). It is this day-to-day passion that reflects the culture. While this derives from an overriding set of beliefs stated by those at the owner, board, or shareholder levels, it only becomes real when practiced by line managers through their leadership skills and through what employees and other partners observe in operational activity. Creating a "culture that cares" closes

the gap between "what we say and what we do." This "culture that cares" also reflects the emerging thinking in the field of behavioral economics.

## COMMUNICATION: A CRITICAL ROLE IN COST MANAGEMENT

Of all the pillars in the behavioral aspects of cost management, communication is the one that is impacted most by the effectiveness of the approach to financial management (see Table 5). There are many reasons that effective communications is one of the greatest challenges for professionals:

- **Language.** Part of any professional training, including finance, is learning a unique language. While this makes sense to the specialist, it can often confuse others.
- **Cost architecture.** Accountants often build cost collection and reporting systems around organizational structures—but this is often *not* the way that processes and costs are driven.
- **Simplification.** In the interests of simplicity, some costs that are hard to identify are spread around among departments (allocated). This may solve accounting needs but often makes little sense to users.
- **Timing and presentation**. In a fast-moving organization, users need information in real time and in an easily understood format. Many accounting systems do not adequately support this need.

### *A. Cost architecture aligned with business*

Finance executives must ensure the cost management system architecture is aligned with the organization's strategy. Cost systems must mature as organizations develop. The competitive global economy and the challenges faced by not-for-profit and other government organizations require a greater degree of detailed costing information than ever before, and they need it fast to make rapid decisions.

The job of the management accountant is specifically focused on this requirement. Since the question was first posed by H. Thomas Johnson in his 1987 book *Relevance Lost: The Rise and Fall*

Table 5. Aspects of Communication

| Aspect | Finance's Responsibility | Finance's Influence |
|---|---|---|
| A. Cost architecture aligned with business | √ | |
| B. Clear cost drivers/process links and alignment | √ | |
| C. Clear responsibility/accountability and no allocations | √ | |
| D. Reports available on demand and in operational language | √ | √ |
| E. Training—finance for nonfinancial managers | √ | √ |

*of Management Accounting,* there has been a continual effort to improve management accounting approaches.[43] There are a number of studies that looked at this issue. For example:

- Survey work in 2005 sponsored in part by IMA looked at combining GPK (German cost accounting) and ABC.[44]
- IMA and the American Accounting Association worked to develop an integrated competency based framework for accounting education.[45]
- FAC and others produced studies that address the maturity of costing systems to support decision making.[46]

In order to support effective decision making, cost information must mirror the structure of the business in the same way that an effective enterprise resource planning (ERP) system reflects operational reality. This discussion on developing a cost collection and reporting architecture has been well researched in the IFAC publications released by the Committee of Professional Accountants in Business.[47]

### *B. Clear cost drivers/process links and alignment*

Creating a foundation of cost information that provides the right level of alignment with accountability and responsibility for processes and projects is no longer enough. Organizations need to be able to answer "what if" questions. The IFAC maturity model clearly demonstrates this need to move from the descriptive continuum to the predictive continuum as organizations develop. The framework is composed of building blocks whereby an organization cannot effectively arrive at the predictive state without the correct architecture of the underlying descriptive data. For instance, the practice of allocating overheads without linking resource consumption to levels of activity or cost objects will render projections of future cost behavior inaccurate and, at worst, misleading for decision making.

Decision makers must have a clear line of sight between the cost data that is collected, aggregated, and reported and their own personal decision making. If this is not in place, it is impossible to move to the predictive phase because the link between operational decisions and costs will not be clear. Financial managers must be able to trace the linkage between the action a manager can take and a change in cost information reflecting a variation in resource consumption. For example, most processes within an organization are interdependent, and a unilateral decision by a manager in one area can easily impact resource consumption and cost in another area.

The need for effective approaches to the tools for collecting and disseminating cost information for the descriptive stage are already well covered in IMA's SMA, *The Conceptual Framework for Managerial Costing.*[48] Ensuring the correct approach is a foundational aspect of creating a cost management system that adds value to decision making. Financial executives should also research publications in areas such as lean management, which creates significantly different demands on accounting.[49]

*C. Clear responsibility and accountability, and no allocations*

The traditional approach of assigning costs to departmental managers and holding them accountable provides information on *who* is doing the spending and *what* is being spent (by GL code such as labor, supplies, and others). The core question it fails to answer is *why* it is being spent. Understanding and control, especially in areas of indirect labor costs is challenging for many organizations. Indirect costs are typically the larger proportion of total cost and are impacted significantly by cross-functional decisions.

This is why tools such as ABC are critical: They illustrate and explain the drivers of cost (the *why*) across boundaries or silos. For effective analytics linked to decision making, indirect costs must be understood in the context of processes and drivers. This is the level at which they are controlled. Once understood in this context, these indirect costs can be attributed to products, services, channels, and other cost objects rather than allocated on some rational basis in order to arrive at the full cost of products, services, channels, and any other object. But even ABC as a tool will fail without cross-functional collaboration.

*D. Reports available on demand and in operational language*

All of these can be considered the mechanics of an effective approach to cost information and must be in place as a foundation for effective communication of cost information that managers can own and link to their decision making. The behavioral aspects of cost management start with an understanding and a "buy-in" to the applicability and relevance of presented cost information. Financial managers must recognize that while the architecture may be right, the information must also be communicated in language that aligns with operational terms rather than finance or accounting "speak." The involvement of operational staff in developing names and terminologies for accounting cost "buckets" (GL, product, service, cost center coding, etc.) will provide a strong foundation. Information must also be available on demand and have the potential to be grouped and structured by the users to meet their needs.

A basic question for accountants should be, "Why do you perform a monthly accounting closing?" There will be many reasons. But if accounting is able to adapt to the progress made in ERP and material requirements planning (MRP) systems, which typically offer real-time operational information that is aligned to day-to-day business activities, then shouldn't accounting information also be available in real time? This type of "on-demand" availability of financial information should be the goal.

*E. Training—finance for nonfinancial managers*

Not many managers like to admit that they do not understand information presented to them, and many think they have a basic knowledge of accounting because they took a Principles of Accountancy class in college. Unfortunately, this is inadequate in the competitive environment that managers face today. The senior financial manager must play an active role in educating and training line managers to understand financial information, including the linkage between cost and their own areas of decision making. While workshops, programs, and courses are available, they are typically generic. Effective understanding does have a generic component, but most managers need to understand financial information—especially the approaches to cost information—in the context of their own business.

Ultimately, costs are controlled by operational line managers and operational decisions. From a behavioral perspective, line managers must be able to align cost information with what they manage, understand the information, and have it available as required, preferably in real time.

## COLLABORATION: MANAGE AND REDUCE COSTS TOGETHER

Historically, many direct costs have been managed by a collaborative approach between product designers, production, process, industrial engineers, and others, but indirect costs were the responsibility of the manager whose budget the costs resided in. Our conversation about the growing interdependence of indirect costs across organizational departments or silos and with third parties has demonstrated that individual managers are more interdependent and that one department's costs may in fact be impacted significantly by operational decisions made outside that department or the organization. The growth in subcontracting of both direct and indirect operational activities has also created an increased level of interdependence between buyers and sellers. As discussed earlier, organizations that have developed effective internal and external relationships have created value—an intangible asset—and possibly a competitive advantage. A key aspect of these relationships is the ability to effectively collaborate on opportunities to reduce cost (see Table 6).

### *A. Provision of process-based cost information*

Alignment between the presentation of financial information and what is managed in an organization is a critical foundation for effective cost control. Process approaches are not new—direct costing, for example, used a process flow concept for the development of standards and tracking of costs. In the same way that production managed the conversion process from input to output through collaboration with purchasing, material management, and other support areas, indirect processes are also interdependent.

Much of the work in quality management focuses on resolving issues that occur between parts of the process as well as within each component. While ABC and similar cross-functional concepts that address this need, such as the cost of poor quality (COPQ), have been around for more than 30 years, they have not been broadly adopted and are still needed to align the cost opportunities of interdependent processes.

Table 6. Aspects to Improve Collaboration on Cost Reduction

| Aspect | Finance's Responsibility | Finance's Influence |
|---|---|---|
| A. Provision of process-based cost information | √ | |
| B. Development of cross-functional teams/process teams | | √ |
| C. Benefit sharing across departments | √ | √ |
| D. Benefit sharing with suppliers and subcontractors | | √ |
| E. Benefit sharing with distributors and clients | | √ |

A simple test that a financial manager can make is to ask people in the organization, "Do you think we waste time and resources here because processes do not work correctly?" That can be followed up with, "And what do you think it costs?" If the answer is, "Yes, we probably waste a lot," or, "I have no idea what it costs," then clearly the cost management system is not providing the information needed to focus decision making on areas where improvements could be made. Recent estimates from experts in Six Sigma place the cost opportunity from poor processes at between 5% and 20% of revenues.[50]

With the balanced scorecard, Robert Kaplan and David Norton demonstrated the need for performance measures in four dimensions: operational process, customer, learning and growth, and financial. Yet many organizations still have not aligned costs with processes. This negatively impacts the ability to benchmark process performance with others to assess the cost per transaction. Many organizations still assess "make or buy" decisions based on costs that include allocations, and they are surprised when overall financial performance fails to improve by the levels anticipated. Ensuring that process-based financial reporting is consistent with work process is a *core aspect* of building an effective approach to cost control.

*B. Development of cross-functional teams/process teams*

Based on the interdependence and cross-functional nature of process management, people inside the organization as well as third parties such as suppliers, distributors, regulators, key customers, and other stakeholders need to be able to work together to develop opportunities for reducing costs. People don't work together naturally. Relationships need time to develop, and this requires investment. Financial managers need to ensure that funding is available to invest in team development activities. There are typically three stages involved:

1. **Developing an understanding of the barriers to effective communications often caused by interaction between different personalities**. These differences often get in the way of collaboration and cooperation. Applying basic development tools such as Myers-Briggs or more definitive tools such as Insights and Lumina Learning can play a key role.
2. **Education and training in team skills.** This provides an understanding of the dynamics created when different people are brought together to work on common problems and opportunities.
3. **Education and training on the use of analytical and problem-solving tools.** To effectively address cost-improvement opportunities, it will be important to gather and analyze existing data as well as to collect new data. With this data, teams will be able to analyze opportunities and work on reducing costs.

There are two key points here: (1) funding and time must be available and will need to be built into budget baselines as a permanent part of orientation training and ongoing development and (2) both education and training are needed—education to understand the "why," and training to understand the "how."

This commitment to training and development is essential to creating a culture that constantly focuses on improvement. The financial manager must ensure budgeted resources are available and that the

training takes place. It is important to apply key metrics that track the training as well as the involvement and outcomes. Tracking the number of teams an organization has and how often they meet is interesting, but it conveys nothing about effectiveness and outcomes. A key success factor for financial managers linked to this aspect is spending time in operations with individual managers, getting to know their activities, and working with them on financial aspects.

*C. Benefit sharing across departments*

Financial managers must influence the organizational understanding of interdependence, and part of achieving this is by placing more emphasis on the organization as an integrated system rather than on departmental budgets. If financial managers are constantly focusing on departmental budget performance, they will reinforce the silos and reduce the willingness to trade off benefits between departments. This is often a problem in public-sector organizations and in organizations that use job-rating models, where the seniority of managers has a strong correlation to budget size. This results in managers being unwilling to give up costs to others for the overall benefit of the organization. Finally, financial managers need to ensure that manager compensation is weighted to include overall performance rather than individual budgets.

*D. Benefit sharing with suppliers and subcontractors*

With the high level of outsourcing and supply chain management, many cost reduction opportunities will come from working with suppliers on the input supply chain side as well as with distributors and clients on the output side. Significant cost reduction from these partnerships has been achieved by moving to electronic data interchange (EDI) and eliminating paper. This reduces administrative cost and working capital through implementing JIT demand and production planning. These mutually shared benefits will only come from successful collaboration.

Financial managers in large organizations that have strong leverage (e.g., purchasing power or market power) have to make sure that they still work with their partners to build relationships even when making these requirements a demand. The "Do it, or we take the business away" approach works, but it likely will alienate suppliers and others and negatively impact the relationships. Being willing to share benefits by developing win/win relationships is a core aspect of working with external partners and one where the financial manager *must* have a high degree of visibility and involvement. A survey estimated that Ford, General Motors, FCA US (formerly Chrysler Group LLC), and Nissan would have collectively improved profitability by more than $2 billion in 2014 if supplier relationships had been better.[51]

*E. Benefit sharing with distributors and clients*

Many organizations deal with the end users: clients or customers through third parties such as distributors or agents. In other cases, such as when franchising the whole delivery aspect of an organization, products or services are contracted out. This again can have a significant impact on both the success of the franchisors as well as on the franchisees' capacity to reduce costs. In fact, there are examples where relationships between

the two have been *very* negatively impacted when one party attempts to force changes between the parties in order to generate one-sided gains. Examples include the friction between McDonald's and its franchisees in issues such as new product introduction or the company's turnaround plan.[52] While the imperative to save cost remains, each partner in any effective supply chain must build a basis for collaboration and trust that recognizes that mutually shared problems must have mutually shared solutions.

## CONTINUITY: ENSURING COST MANAGEMENT IS A WAY OF LIFE

Organizations must ensure that the focus on effective cost management never becomes a secondary area of interest or reduced to a concern only with large savings (see Table 7). Every area should always be open to improvement. There is often a temptation in good financial times to back off from the focus on cost, but this must not happen. Cost cannot be seen as important only some of the time.

### *A. Understand and reinforce life-cycle thinking*

To sustain a continual focus on cost management, financial managers must encourage thinking about it from a life-cycle perspective. For example, BCG Portfolio Planning Model discussed earlier identified the four stages of product (or service) life: the star, the question marks, dogs, and cash cows. This can be overlaid on the introduction, growth, maturity, and decline stages of products and services, serving as a basis to align cost strategies. This model creates a great foundation for this type of structured thinking.

From a cost perspective, organizations need to spend and invest in their early stages (introduction and growth) to create market share. As this happens, however, competition is developing and starting to drive down margins. Unfortunately, organizations often wait until the product maturity stage, when they see margins eroding, to respond with cost reduction programs. Progressive organizations start cost reduction thinking right at the beginning, well in advance of pressure on margins, so that they are prepared. These organizations constantly reassign resources out of growing and maturing products to new and evolving ones, thus following the BCG model and creating the cash cow as a feeder for investment elsewhere.

### *B. Avoid cost reduction initiatives as only "programs"*

There must be a continuity of purpose around continual improvements, which in many cases needs to be a value or principle embedded in the organizational culture. Initiatives such as Kaizen teams for cost

Table 7. Aspects of Continuity

| Aspect | Finance's Responsibility | Finance's Influence |
|---|---|---|
| A. Understand and reinforce life-cycle thinking | √ | √ |
| B. Avoid cost reduction initiatives as only "programs" | √ | √ |
| C. Constantly communicate "business reality" | | √ |
| D. Identify, track, and communicate and share savings | √ | |

improvement are a valuable concept, but they must be applied continuously along with the ongoing focus on cost improvement everywhere across an organization.

Kaizen alone is not enough! When the Deming talked about his 14 principles, one of which was shunning "programs and exhortations," this is what he was focusing on: the need to develop constancy of purpose. In the cost management context, Deming's principle illustrates that cost reduction is not something to be turned on and off depending on how well things are going for the business. The effective financial manager should be very cautious about creating a culture where people believe that if business is doing well and there is no cost reduction program, then spending can go ahead. (And the solution is not budgetary compliance.)

*C. Constantly communicate "business reality"*

Financial managers must be the "evangelists of reality" in communicating the reality of the business challenges that the organization faces. Employees in many organizations are often not well informed about the overall state of competition within their sector or industry. As a result, they often blame management for efforts to reduce costs rather than recognizing the need in order to stay in business. Regularly reporting back to employees about both the results of the organization's financial performance as well as that of the competition is a facet of effective financial management.

Some organizations implement concepts such as "open book management," which involves the broad and open sharing of financial information with employees at all levels.[53] This approach provides employees with a context for the challenges the organization is facing, helping them understand why change and cost reduction may be a reality and necessary—and dispelling the notion that the cost cutting is just management's desire to improve their bonuses. Sustaining education on the reality of business will provide context and help build an organizational culture that is ready for change.

*D. Identify, track, communicate, and share cost savings*

The financial manager needs to build constant communication to sustain a culture of cost awareness and to ensure that communications of cost savings take place and are celebrated on a regular basis. Many organizations implement suggestions as a way of encouraging cost savings ideas, yet these efforts often fail because employees become demoralized by the slowness of the process and the lack of feedback.

Cultures that encourage cost-saving ideas typically include a rapid response approach where ideas are reviewed within a short time frame. There is typically an ongoing communication of how the idea is progressing and what results have been achieved. Creative communications by the financial manager can include presenting this information in a way that provides impact. An example of this would be an individual who suggests a cost savings that results in $10,000 per year. This could be communicated as just that: a $10,000 saving or, if the organization generates a 5% return on revenues, it could be expressed as creating the equivalent of $200,000 more revenue. Which form of communication do you think provides a greater marketing impact?

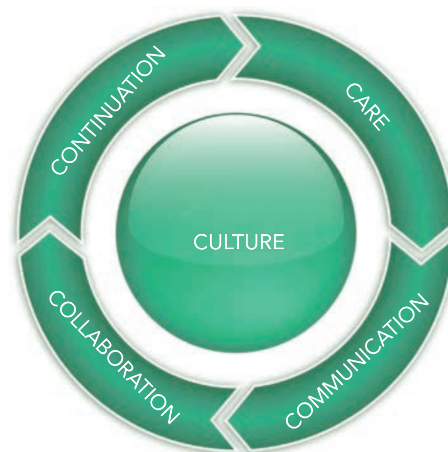
# Conclusion

The ability to reduce cost is a core requirement for most organizations, whether public or private, for-profit or not-for-profit. Competition is tough, and resources are constrained. How is it that some organizations seem to succeed in constantly addressing the need to lower costs while others seem to implement short-term and temporary programs to seek out and eliminate cost? The answer is that successful cost reduction is not a program but an underlying culture. People within an organization must *want to reduce cost*. They must be constantly seeking out, recommending, and implementing approaches that drive down the cost of everything and anything the organization does.

Cost improvement and cost control are increasingly driven by the innovation and creativity of individuals at the front lines. Employees in organizations that have embraced a lean management approach are empowered to take responsibility for management and control of work processes that drive resource consumption and thus cost. With significant outsourcing of materials and services, the role of suppliers and contractors in contributing to cost reduction has also grown as an operational imperative. Approaches such as Kaizen are often implemented to constantly address opportunities for cost improvement internally and externally.

At the end of the day, it is people who control costs, not accounting reports or systems. Frustrated entrepreneurs often struggle with cost management as their organizations grow because employees do not treat expense control like they were handling their own money. What is needed is an integrated approach for balancing the task of cost reduction while sustaining the important relationships that make the system work.

Figure 5. The 5C's



The foundation of an integrated approach comes from the culture, which is developed by creating an environment where people actually care about cost. To make this happen, there must be good, relevant cost information and communication. To actually make decisions that take cost out of the system requires support and collaboration. Finally, cost improvement should not be a program that is turned on and off when needed. It must be part of a culture of continual improvement in everything the organization does.

The ability to have people think this way can only be achieved by developing a sustainable culture that makes cost management a way of life. It is most important to think in terms of the effective use of limited resources than to just focus on control. Once people take personal responsibility and accountability, cost management will become much more than just a program.

Only through a constant focus on cost savings and improvement can an organization reinforce a culture of effective cost management. Knee-jerk reactions to cost management are often a result of not effectively managing an organization's cost portfolio. This, in itself, is often a problem because costs are aggregated at a level that is too broad, without the recognition of cost drivers. Costs are therefore not effectively linked to products, services, channels, customers, key drivers, and life cycles. Most importantly, resource consumption and costs are not linked to the day-to-day decisions made by managers and employees.

Successful and constant cost reduction requires financial managers to make effective decisions. They need to be thoughtful in their approaches to collecting data to calculate and report cost information so that the managers and employees responsible for managing resources that drive the levels of cost can understand the impact of their decisions. They must pay an equal amount of attention to the culture of the organization that provides the context within which everyone at every level becomes committed to the constant approach to cost reduction. Unless people's actions support the desire to reduce cost, the best systems and approaches in the world will become suboptimal.

Changing an organization's culture so that approaches to cost management are institutionalized is very hard to achieve. Having a model like the one that is outlined in this SMA creates the framework to balance "task" and "relationship." Yet finance managers might wish to develop the concepts further and investigate a four-stage process to approach improved cost management using what has been discussed in this SMA as a model.

A depiction of the further steps in effective cost management is shown in the exhibit at the end of this SMA. This exhibit is based on the concept of the 5C's but uses more of a "building blocks" approach to implementation. Cultural changes may take some time to implement and can continue through several years. But, typically, cultures can shift in three to five years of sustained effort, and there are steps that can be taken in parallel. For example, organizations can start engaging with employees by implementing the core aspects of COPQ. This approach will start to get managers aware of the opportunities that are available and will create a focal point of collaboration at the team level on individual process problems.

# Appendix: A Step-by-Step Approach to Implementing Cost Management

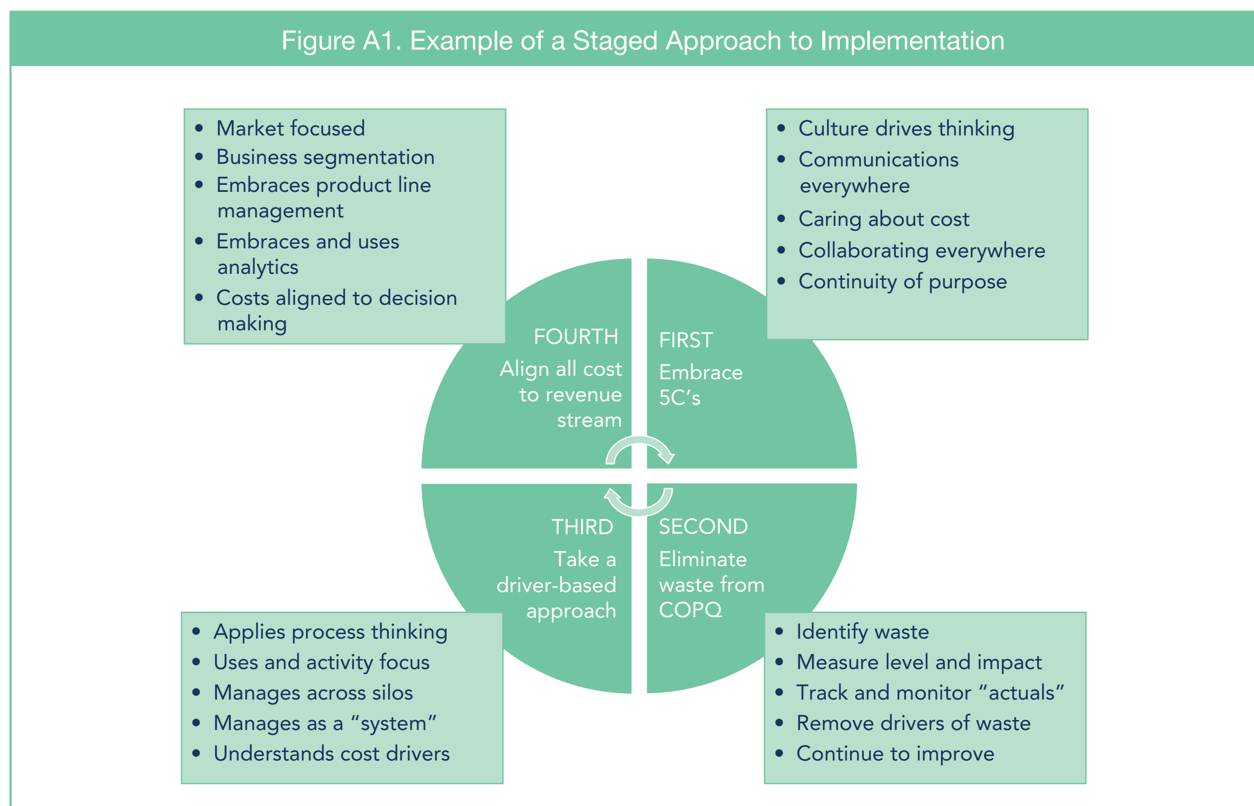
Creating an effective behavior-based approach to cost management can take time. Some financial managers may wish to approach the implementation of these ideas on a step-by-step basis. The four-stage model in Figure A1 is helpful in thinking through an implementation approach.

First, financial executives would start in Quadrant 1 by implementing the balanced task and relationship model as discussed in this SMA. This would involve creating the underlying strategic culture for effective cost management even though some of the tools and processes may not be in place yet.

Second, quadrant 2 depicts implementation of COPQ concepts as developed by the American Society for Quality. This approach would achieve two goals: to identify opportunities for cost improvement and to start engaging employees in collaboration across departmental boundaries by using a process focus.

Third, quadrant 3 depicts moving to a costing framework that understands and aligns the architecture to the cost drivers of the organization. This would require significant operational involvement of the financial manager in working with line managers to align cost collection, retention, and reporting with operational decision making. This might also involve systems changes and improvements.

Figure A1. Example of a Staged Approach to Implementation



Finally, Quadrant 4 depicts moving the organization's reporting of cost completely away from allocations and might include shifting to a product lifecycle management (PLM) approach where all costs are tracked back to individual earnings statements that align income to (full) expenditure. The application of ABM and GPK concepts can help address this. At this stage, financial information should align with decision making around products and services and reflect an understanding of the source of real profitability.

Continual improvement would then come from the constant enhancement of the cost management framework and improvements and changes based on what is learned when applying the information produced by the new system.

# Glossary

Many organizations have been referenced in the text. Readers should find this glossary helpful in their own research and development of ideas. Cost management and reduction is a global issue, and there are many organizations doing research, both individually and collaboratively, to improve approaches used by accountants.

**ACCA:** The Association of Chartered Certified Accountants is a UK-based global body for professional accountants. ACCA offers business-relevant, first-choice qualifications to people of application, ability, and ambition around the world who seek a rewarding career in accountancy, finance, and management. ACCA supports 178,000 members and 455,000 students in 180 countries, helping them to develop the skills needed for successful careers in accounting and business.

**Balanced Scorecard (BSC):** The balanced scorecard is a strategy performance management tool—a semi-standard structured report supported by design methods and automation tools that can be used by managers to keep track of the execution of activities by the staff within their control and to monitor the consequences arising from these actions.

**Baldrige Award:** The Baldrige Program is the U.S. public-private partnership managed by the National Institute of Standards and Technology (NIST), dedicated to performance excellence. The Baldrige Program raises awareness about the importance of performance excellence in driving the U.S. and global economy, provides organizational assessment tools and criteria. The Baldrige Program also educates leaders in businesses, schools, health care organizations, government, and not-for-profit agencies about the practices of best-in-class organizations. The program recognizes national role models and honors them with the Presidential Award for Performance Excellence.

**Chartered Institute of Public Finance and Accountancy (CIPFA):** Located in London, U.K., CIPFA is the professional body for people in public finance. Its 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed. As the world's only professional accountancy body to specialize in public services, CIPFA stands up for sound public financial management and good governance around the world.

**Committee of Sponsoring Organizations of the Treadway Commission (COSO):** COSO's mission is to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control, and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations. COSO partners are AAA (American Accounting Association), AICPA (American Institute of Certified Public Accountants), FEI (Financial Executives Institute), IIA (Institute of Internal Auditors), and IMA.

**Economic and Social Research Council (ESRC):** ESRC is the U.K.'s largest organization for funding research on economic and social issues. It supports independent high-quality research that has an impact on business, the public sector, and the third sector.

**Institute of Chartered Accountants in Australia (ICAA):** ICAA is the professional body representing chartered accountants in Australia. Its reach extends to more than 67,000 of today's and tomorrow's business leaders, representing more than 55,000 Chartered Accountants and 12,000 students.

**International Federation of Accountants (IFAC):** IFAC is the global organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC comprises more than 175 members and associates in 130 countries and jurisdictions, representing approximately 2.84 million accountants in public practice, education, government service, industry, and commerce.

**IFAC's Professional Accountants in Business (PAIB):** PAIB is a working committee of IFAC. Members in industry are diverse, and they work in commerce, industry, financial services, education, and the public and not-for-profit sectors as employees or advisors. Many are in a position of strategic or functional leadership or otherwise well placed to collaborate with colleagues in other disciplines to help drive their organizations' sustainable success.

**National Institute of Standards and Technology (NIST):** NIST was known as the National Bureau of Standards (NBS) from 1901 to 1988. It is a measurement standards laboratory, also known as a National Metrological Institute (NMI), which is a nonregulatory agency of the United States Department of Commerce.

**New Zealand Institute of Chartered Accountants (NZICA):** NZICA is the membership body of choice for more than 33,000 accounting and business professionals working in New Zealand and across the globe.

**Sarbanes–Oxley Act of 2002 (SOX):** Known as the Public Company Accounting Reform and Investor Protection Act (in the Senate) and Corporate and Auditing Accountability and Responsibility Act (in the House of Representatives), and more commonly called as Sarbanes–Oxley, SOX, is a U.S. federal law that set new or expanded requirements for all U.S. public company boards, management, and public accounting firms.

**Taylorism:** Research and work attributed to the industrial engineer and proponent of scientific management Frederick Taylor (1856–1915). Taylor laid the groundwork for the development of works standards that led to standard costing.

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