

Some Theoretical and Methodological Problems of Cost Management Efficiency Assessment

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In scientific literature, as well as in international practice, the dominant approach is that the cost management efficiency assessment is carried out on the basis of the cash flow management efficiency assessment.

The purpose of the work is to identify modern theoretical and methodological problems of cost management efficiency assessment and, on this basis, to develop new approaches to assessing the efficiency of this process.

Material and methods. *The study is based on the methods of critical analysis, system and institutional approaches, deduction and induction methods. The materials are scientific works of Chinese and English-speaking scientists.*

Findings and their discussion. *The most common indicators for assessing the effectiveness of cost management are of narrow-purpose character; they are not universal. As a result of the spread of the strategic approach to cost management, asset turnover, marginal profit, and cost rigidity are usually used to assess the effectiveness of cost management. This approach leads to considering cost management to be identical to financial management. Almost all existing methods leave room for manipulation and distortion of the results of production and economic activity, which, however, is not a violation of the legislation on accounting policy.*

Conclusion. *In order to overcome these shortcomings, the assessment of the effectiveness of cost management should be based not on the assessment of cash flows, but on the achievement (or not) of strategic goals of the company. The object of cost management should be the efficiency of using resources to achieve the set goals.*

Key words: *cost management, strategic management, efficiency assessment, management.*

Некоторые теоретико-методологические проблемы оценки эффективности управления затратами

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В научной литературе как и в международной практике доминирует подход, в соответствии с которым оценка эффективности управления затратами осуществляется на основании оценки эффективности управления денежными потоками.

Цель данной работы заключается в выявлении современных теоретико-методологических проблем оценки эффективности управления затратами и на этой основе выработке новых подходов к оценке эффективности данного процесса.

Материал и методы. *Основой исследования послужили методы критического анализа, системный и институциональный подходы, метод дедукции и индукции. В качестве материала выступили научные труды китайских и англоязычных ученых.*

Результаты и их обсуждение. *Наиболее распространенные показатели оценки эффективности управления затратами носят узкоцелевой характер и не являются универсальными. В результате распространения стратегического подхода к управлению затратами для оценки эффективности управления затратами обычно используют оборачиваемость активов, маржинальную прибыль и жесткость затрат. Такой подход приводит к отождествлению управления затратами с финансовым менеджментом. Практически все существующие методы оценки эффективности управления затратами оставляют возможности для манипулирования и искажения результатов производственно-хозяйственной деятельности, что тем не менее не является нарушением законодательства.*

Заключение. *Для того, чтобы преодолеть указанные недостатки, оценка эффективности управления затратами должна базироваться не на оценке денежных потоков, а на достижении (недостижении) стратегических целей фирмы. При этом объектом управления затрат должна выступать эффективность использования ресурсов для достижения поставленных целей.*

Ключевые слова: *управление затратами, стратегическое управление, оценка эффективности, менеджмент.*

Modern cost management theory belongs to management theory, and cost management is traditionally considered as part of enterprise management. As cost management practice develops, taking place against the background of deeper transformations of economic systems

and corresponding changes in management theory, there is a gradual evolution of scientific views on cost management. Adherents of the traditional approach (Yu Jiajia [1], Jiao Yuehua [2], Zhao Wenjing [3]) interpret cost management as cost reduction. As it develops, the traditional approach

is reborn into an optimization approach. Supporters of the optimization approach (Shen Weijun, Shen Shaojun [4], Zilian Li, Qiumei Hu, Jie Huo [5]) also consider the main task of cost management to be their reduction, however, not total, but in individual segments (reduction of irrational costs). In the 1980s, a strategic approach was developed, according to which cost management depends on the business model of the enterprise and the directions of its development. The strategic approach has a large number of supporters: Banker R.D., Mashruwala R., Tripathy A. [6], Purba G.K., Fransisca C., Joshi P.L. [7], Qin Yun [8] and others. Within the framework of the administrative-controlling approach (Wan Xiuhua [9]), cost management is considered as a process of organizing the accounting and control of enterprise costs. This approach is fundamentally different in that cost management is reduced only to reflecting ongoing business processes and achieving established cost indicators, while the definition of these target indicators is taken out of scope.

The administrative-controlling approach is as widespread in scientific literature as the strategic one. But the contexts in which they are used are different. In works on management that study the directions, reasons and motives of enterprise management, the strategic approach dominates. However, in works devoted to the development of specific tools for accounting, analysis and planning of costs, the administrative-controlling approach serves as the methodological basis for the study. And if in the first case cost management is considered as part of the enterprise's business strategy, then in the second case cost management is reduced to the accounting policy of the enterprise (as part of accounting or tax accounting), that is, it does not go beyond the framework of financial management. Until now, in scientific literature (neither Western English-speaking scholars, nor Eastern, in particular Chinese) it has not been possible to logically and scientifically reconcile these two approaches. This is one of the main reasons that have given rise to many theoretical and methodological problems in assessing the effectiveness of cost management. Let us consider them in more detail.

Material and methods. The study is based on the methods of critical analysis, system and institutional approaches, deduction and induction methods. The materials are scientific works of Chinese and English-speaking scientists.

Results and their discussion. Today, in scientific literature, as well as in international practice, the dominant approach is that the assessment

of the effectiveness of cost management is carried out on the basis of the assessment of the effectiveness of cash flow management. In particular, within the framework of one of the most common approaches, the following serve as performance indicators: asset turnover and marginal profit.

If a company adheres to a cost leadership strategy, then it is proposed to use asset turnover operation as the most important indicator [10], "because it shows how well a company uses its resources to achieve operational excellence and, consequently, the level of leadership it practices" [11, p. 51].

For a firm that pursues a differentiation strategy, that is, seeks "to obtain a competitive edge through the special and distinctive qualities of the goods and services that are provided to clients", the profit margin is considered to be an indicator of cost management efficiency [11, p. 51].

This approach to assessing the effectiveness of cost management was formed as a result of the development of a strategic approach to cost management. Its advantages include the development of various indicators for companies with different strategies: for a cost leadership strategy-asset turnover, for a differentiation strategy-marginal profit. The ease of use of these indicators has not least ensured their distribution in assessing the effectiveness of cost management. Moreover, these indicators also reflect the overall financial position of the company (and are not limited exclusively to costs), which allows cost management to be linked to the company's strategy.

However, this approach has a number of disadvantages, the first of which is that it leads to the identification of cost management with financial management. This gives rise to a number of other problems, which will be described below.

Another common metric used to evaluate the effectiveness of cost management is cost stickiness. It can be used in addition to asset turnover and contribution margin. Cost stickiness is defined as the situation where "a company's expenses increase more when its business volume increases than they decrease when its business volume decreases," in other words, "the asymmetric changes in a company's expenses as its business volume increases and decreases" [12, p. 487]. Anderson, Bunker, and Janakiraman first showed that when companies' sales increase by 1%, their expenses increase by 0.55%; however, when their sales decrease by 1%, expenses decrease by only 0.35% [13]. Citing other researchers, Hartlieb and Loy note: "Asymmetric cost behavior has been shown for

a variety of cost categories, including selling, general, and administrative (SG&A) expenses <...>, cost of goods sold (COGS <...>), operating expenses (OC <...>), or labor costs (<...>)" [14, p. 3917].

This phenomenon is often interpreted as negative, since one of the reasons for its occurrence is the agency problem: "managers may engage in self-interested behavior when making decisions about resource allocation" [12, p. 487]. The treatment of cost rigidity as an economic problem of the firm may be acceptable only in a very narrow context, for example, as in the study of Chen et al., which is devoted to studying the effect of "dividend regulation on cost rigidity (i.e., the asymmetric change in the firm's costs between sales growth and decline)" and studying the underlying mechanism [12]. Indeed, when analyzing the agency problem and dividend policy of a listed company, cost rigidity can be used as indirect evidence of opportunistic behavior of managers. It is noteworthy that most studies devoted to the problem of cost rigidity analyze exclusively listed firms.

However, this does not mean that such a phenomenon as cost rigidity is a sign of ineffective cost management. Among the causes of cost rigidity, scientists also highlight adjustment costs (e.g. severance pay to laid-off employees, costs of disposal of unsold goods) [13], underdevelopment of factor markets [15], social protection [16] and protection of human capital [17], management's optimistic expectations, related to the future expansion of the company's activities in the context of industry and (or) macroeconomic growth [18]. As Hartlieb and Loy write, "asymmetric cost behavior might arise because managers make economically rational trade-off decisions and compare the adjustment costs with the holding costs of committed resources" [14, p. 3914].

Thus, theoretically, the phenomenon of cost rigidity can be interpreted as a problem for firms that are primarily focused on the capital market and pay more attention to the interests of shareholders. However, if we take into account that the modern capital market is influenced primarily by the news flow in the media, and not by objective financial and economic indicators, then this problem also largely loses its relevance. From the point of view of managing the capitalization of assets and the image of the company in the stock market, cost rigidity, in our opinion, is not a problem that requires a priority solution. Such assessment mechanisms have been developed and are suitable only for investors (the authors of works on cost rigidity analyze listed

companies [11]). At the same time, however, from the point of view of managing the company's costs as part of strategic development, cost rigidity is an informative indicator that necessarily requires analysis and is subject to management.

In addition to the fact that existing methods of cost management assessment are narrowly targeted and not universal, another problem that can be considered the most serious is the widespread practice of financial reporting manipulation. This problem is caused by the mismatch of economic interests of top managers, investors and large owners of enterprises. Despite the fact that most scientists studying cost management are silent about this problem, there are studies that describe it in great detail. One such study is the work of Kollar "Web Globalization and Its Possible Consequences on the Usage of Different Creative Accounting Techniques" [19].

Referring to Schipper [20], Healy and Wahlen [21], United States Securities and Exchange Commission (SEC) [22], Mulford and Comiskey [23], Kramarova and Valaskova [24] Kollar gives the following definitions of the term "Earnings management", which is actually equated to fraud:

- "purposeful intervention in the external financial reporting process with the intention of obtaining personal gain";

- "managers use judgments and conjectures in financial reporting in a way that allows financial results to be changed to give investors a distorted view of the company's financial situation, or to affect the output of contracts depending on the amount of the reported accounting results";

- "aggressive practice used by listed companies, which involves the application of various forms of fraudulent techniques aimed at distorting a company's real financial results to achieve its own desired objectives";

- "active manipulation of a company's financial results in order to show the company's economic situation in the best possible light" [19, p. 2].

One should agree with Kollar and make a distinction between "earnings management" and "purposeful and legal management". The named author suggests distinguishing 3 categories of earnings management:

- a) black earnings management: "In this case, earnings management is based on the application of such practices and procedures that seek to distort or reduce the transparency of financial statements" [19, p. 2];

- b) grey earnings management: "...earnings management is the choice of accounting method

based on an opportunistic approach (an effort to maximize utility) or an approach based on economic efficiency” [19, p. 2];

c) white earnings management: “Approach based on the flexibility of the accounting method choice, while the level of flexibility allows to indicate information of a private nature about the future cash flows in the company” [19, p. 2].

The following findings from Kollar's work are of interest in this study:

firstly, proof of the existence and description of practices of manipulation and distortion of the results of the production and economic activities of the enterprise using various methods of assessing its financial activities;

secondly, the existence of an extremely wide range of accounting methods and procedures that can be used either to distort financial statements (black earnings management) or to achieve opportunistic goals (grey earnings management), or to improve the quality of financial accounting by taking into account the specifics of an individual company (white earnings management). According to Kollar, “earnings management may also result in an increase or decrease in reported profit, which may be considered harmful, if it contributes to minimizing the value of the business, but may also be considered beneficial, if it allows more information about the business to be obtained in the future” [19, p. 3];

thirdly, even “black earnings management”, which leads to actual distortion of information about the enterprise, as a rule, is not a violation of accounting policies [19, p. 3]. Manipulation of financial statements, unless it involves, for example, “recording fictitious or unrealized sales”, still remains within the framework of accounting rules established by law.

Fourth, there are many different and competing motives for financial reporting manipulation. Kollar, citing Watts, Zimmerman [25] and Monem [26], writes that “companies are more likely to choose revenue-reducing manipulation to reduce political costs, because favorable accounting numbers may attract regulatory intervention” [19, p. 5]. In addition, “Managers are looking for ways to avoid tax obligations by practicing earnings management” [19, p. 5]. However, most of the motives listed by Kollar are directly or indirectly related to the need to maintain the company's image on the stock markets: “achieved profit is lower than was determined by the market on the basis of the forecast of the development of the economic result to avoid a possible fall in stock prices”, “avoid

the negative reaction of investors to the differences between the achieved result of the company and the expected trend of profit development” and others. It is the stock exchanges, according to Kollar and Haw [27], and led to the spread of the practice of earnings management: “In the Chinese economy, earnings management was not practiced to adjust the tax base, but the motive for its implementation was the need to meet the condition regarding the accounting rate of return on equity (ROE), as only those companies that were able to meet the condition of reporting ROE in the range of 10%–11% within three following years, were qualified to perform on the stock exchange” [19, p. 5].

In scientific literature, the problem of financial accounting manipulation is also considered through the concepts of “Real Earnings Management (REM)” and “Accrual-based Earnings Management (AEM)”.

According to Roychowdhury, REM is “departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations” [28, p. 337]. Kollar, mentioned above, is of a similar opinion: “When practicing REM, the company's activities differ from the company's normal activities performed by managers, with the aim of misleading certain interest groups” [19, p. 4]. Xuerong and Li define REM as a neutral action that does not necessarily have a negative context: “REM is manager's purposeful action that deviates from the optimal business practice to alter reported earnings in a particular direction” [29, p. 91].

REM practices are often analyzed through strategic cost management theory. For example, Wu, Gao, and Gu argue: “The firms that follow cost leadership strategy (cost leaders) are more likely to have a higher level of real earnings management. The firms that follow differentiation strategy (differentiators) are less likely to use real earnings management” [30, p. 401].

In contrast to REM, accounting earnings management (AEM) is “earnings management with the use of accounting principles, which is called accounting earnings management” [19, p. 4]. AEM is “based on accruals, the purpose of which is to capture revenue and expenses truthfully in the period in which they are incurred”, while it “does not affect the cash flow of the company” [19, p. 4].

An example of intentional distortion of financial statements may be overstating expenses on depreciation, asset restructuring, formation

of reserve funds, which leads to a decrease in profit indicators. Profit may also be intentionally overstated, for example, by understating reserves for abandoned claims. Reduction of R&D or marketing expenses, accretive share repurchases, classification shifting (“the process of vertical movement of items, ie, shifting expenses from core expenses, such as cost of sold goods, and selling, general and administrative expenses, to special items in order to inflate core earnings”) [31, p. 4334], smooth income stream [32; 14; 33] can also be classified as REM. This is not an exhaustive list of what can be classified as REM. It is important to note that such practices are very dynamic. They are constantly being improved, developed, and take on new and new forms.

In our opinion, the criterion that allows us to clearly determine whether a practiced accounting policy is unfair is whether there is an intention to mislead one of the interested parties: investors (current or potential), the state, tax authorities, etc.

Although REM is often defined as, if not fraud, then at least manipulation with the intent to deceive, REM is not always viewed as a negative phenomenon in the scientific literature. Some researchers simply acknowledge the existence of this practice and study individual aspects of its use. In such studies, for example, the scientific task is often to determine whether the benefits of using REM outweigh the costs associated with its implementation.

Some researchers even prove the usefulness of REM. In particular, within the framework of the efficiency theory of REM (one of the theories designed to explain why managers use REM), it is generally accepted that “firms with a solid financial performance utilise REM to reduce information asymmetry in the capital market, and to signal future economic growth” and “the negative impact of REM is outweighed by the positive benefits derived from information conveyed to the capital markets” [31, p. 4282]. Proponents of the efficiency theory of REM are, for example, Gunny [34] and Zhao, Chen, Zhang, Davis [35]. According to Demski [36], Kirschenheiter and Melumad [37], Raman and Shahrur [38] managers primarily use income smoothing to provide additional private information about future income and cash flows. Moreover, there is the so-called “ethical point of view” [39], as indicated by Habib et al. in their study, according to which “managers perceive REM as more ethical than AEM” [31, p. 4283].

Opportunistic theory of REM [for example, 28; 40] believe that “REM creates information asymmetry

and triggers agency frictions in the form of adverse selection and moral hazard problems” [31, p. 4282]. They highlight such negative consequences of REM as a decrease in the efficiency of the firm, a negative impact on the stock and debt market (precisely due to information asymmetry).

Notable is the “abundance of research on REM in public firms” compared to the fact that only “few studies have examined REM practices in the nonprofit sector and REM practices in private firms,” as noted by Habib et al. [31, p. 4335]. Because of this, an idealized view is formed in the scientific literature, according to which REM, firstly, is not always something unacceptable, since it may be caused by a desire to improve the efficiency of the company, and secondly, even if its negative consequences are recognized, they are most often associated with state-owned firms (i.e. firms that a priori operate outside the framework of the laws of the market economy). Thus, when considering the REM problem, the underlying economic reasons for its occurrence, associated with the consistent development of market forms of management, are taken out of the scope of the subject field of research: competitive struggle (inter-firm and intra-firm), corporatization, the agency problem and stock markets.

Roychoudhury has made the most significant progress in developing methods for identifying and assessing REM. He proposed assessing REM according to 3 criteria:

- abnormal production costs (measured as the ratio of the sum of the cost of goods sold and inventories of the current period to the total assets of the previous period);
- abnormal discretionary expenses (measured as the ratio of discretionary expenses (R&D, advertising and SG&A expenses) in the current period to total assets of the previous period);
- abnormal levels of cash flow from operations (measured as the cash flow from operations in the current period to the total assets of the previous period).

The measures developed by Roychoudhury are valuable in that they can help identify REM. However, they need to be interpreted correctly. For example, “a high ABN_PROD (abnormal production cost—author’s note) value represents REM, given that firms are increasing their production levels to reduce fixed costs per unit to show higher profit margins” [31, p. 4283–4284]. How does this differ from the classic positive effect of scale, used for hundreds of years by companies all over the world? When does a manager’s decision to expand production

become a REM? Obviously, when production is increased without a corresponding increase in sales and goods accumulate in the warehouse. However, in addition to the intention to inflate the profit margin in the reporting period, a manager may be guided by other motives when making such a decision: providing jobs (social motives), planning a quick conquest of new markets, forecasting an increase in demand for goods in the near future (especially seasonal goods), and much more. The same problem arises in relation to assessing the reduction of discrete costs or the level of cash flow from operations.

Choi et al. note that "... it is difficult ... to distinguish opportunistic REM from operational adjustments based on optimal business decisions" [41, p. 2229]. In other words, the calculation itself does not show anything. It is only the first step, requiring subsequent deep analytical work, to the so-called qualitative investigations, which allows us to identify the motives. And since we are talking about the motives of managers, it is often impossible to get a clear answer as to whether this practice is REM, that is, deliberate misrepresentation, or a strategic business decision.

Many scientists are making efforts to further improve the mathematical tools that allow identifying REM. As a rule, the number of criteria used is expanded for this purpose. Gross margin, book-to-market, firm size and its performance are proposed as additional indicators [42], return-on-assets [43] and others.

Despite the variations in the indicators, all of these models operate on the same principle: identifying deviations in a firm's behavior that may be REM based on comparisons with the behavior of other similar firms (with similar sizes and business models) within an industry. This approach cannot be considered reliable. This is also pointed out by Habib et al.: "Cross-sectional models, however, have low explanatory power, because they fail to capture the complexities of the firm-level underlying economics" [31, p. 4284]. Moreover, with this approach, if the REM practice is used by the majority, then it becomes impossible to detect it.

Of particular interest are the methods for combating REM. The first and most obvious among them is administrative, that is, the establishment of clear standards of financial (accounting) reporting. However, based on a large amount of scientific literature analyzed, Habib et al. in their research come to the following, at first glance, paradoxical, conclusion: "Our review of financial reporting and REM do not give a clear indication about whether

reporting standards are effective in constraining managerial opportunism. Although reporting standards aimed at curtailing managerial opportunism is desirable, managers with opportunistic intentions might increase REM which could adversely affect financial reporting quality. Therefore, the trade-off between AEM and REM has received significant research attention" [31, p. 4287]. The authors named further explain their position: "passage of the SOX failed to curb earnings management practices, and an unintended consequence of the SOX¹ is manifested by managers switching to harder-to-detect REM activities" [31, p. 4297–4298]. It is important to note that the adoption of International Financial Reporting Standards (IFRS) also does not fully address this issue: "IFRSs are more detailed, and broader in scope, than many local accounting standards, and are expected to enhance corporate transparency <...>. However, empirical evidence on the impact of IFRS on REM remains mixed" [31, p. 4297–4298].

External auditing has also become a popular tool to address the REM problem. However, as research by Chi et al. shows, an unintended consequence of better auditors has been the shift of American firms from AEM to REM [43]. Alhadab and Clacher found that the presence of high-quality auditors for IPO firms limits manipulation of AEM and REM via ADISX (intraday, historical and comparison charts, technical analysis and trend lines), but carry out manipulation based on sales in order to increase profits at the end of the year: "A divergent trend between increasing sales and the costs associated with increasing sales would be a signal to high-quality auditors that there may be pervasive manipulation going on" [44, p. 445].

Independent board should, labor representation on the board and other formal requirements for the internal mechanism of corporate governance aimed at the participation of various stakeholders in this process can also be used to prevent REM. All these measures are initially aimed at solving the agency problem, and since REM may be a special case of its manifestation, they can also have a positive effect on increasing the transparency of financial reporting.

Conclusion. In order to overcome the above-mentioned shortcomings of existing methods of cost management efficiency assessment (identification of cost management with financial management, manipulation of financial reporting in order

¹ Sarbanes-Oxley Act of 2002. (2002) Sarbanes-Oxley Act of 2002: Conference report (to accompany HR 3763). Washington, DC: US GPO.

to overstate the cost management efficiency indicators), it seems appropriate to assess cost management based on the achievement (non-achievement) of strategic goals and the corresponding tactical objectives of the company. At the same time, the object of cost management assessment is the efficiency of resource use to achieve the set goals.

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