

THE CRISIS AND THE COST MANAGEMENT

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ABSTRACT: The aim of the present study is the analysis of the phenomenon of contemporary crisis and its unfavourable effects upon the global economy, in general, and the developing countries, in particular. It also has in view the most appropriate decisions that the management of an entity should take under recession conditions. The reduction of prices becomes a priority for the entities, and the first anti-crisis measure in the present economic context. More attention should be paid to the reduction of fixed and variable costs, taking into account the aim of maintaining the profitability and financial equilibrium into an instable and unpredictable business environment.

Key words: economic crisis, reduction of fixed and variable costs, the descending spiral of demand, sub-activity cost.

JEL codes: M41 – Accounting

Introduction

The world today confronts with the darkest days of recession since 1930. Despite the fact that the crisis did not originate in the developing countries, these countries are strongly affected by a weak trade, more severe financial conditions and low improvement (the substantial decrease of foreign capital entrance). There is also an increased risk of accelerated environmental degradation, and the social tensions are also growing.

The years before the crisis were characterised by an accentuated global economic crisis and a relatively stable and low inflation in most of the countries. This pattern of growth combined with the deficit regularization finally resulted in overcapitalized entities and financial institutions that proved to be non-sustainable.

The world chase after more money has been accompanied by the growing international financial want.

Literature review

The increased cost of external loans alters the level of debt in many countries. Approximately 3.000 billions \$ from the state external debt to which more than 1.000 billions \$ external debt of the private sector are added have their dead-line in 2009. The costs of these debts will be higher than the ones they had in the moment when the loan was done. The interest sustainability underwent major stress conditions in the countries with low toward medium income population because of numerous factors: low growing quotas, low export income, exchange rate fluctuations, and the depreciation of the national currency that affect both the state budget and the budget of the private entities.

Trade has registered massive decrease in the entire world even since the end of 2008, and it continued to fall off in the first quarter of 2009 with an annual rate of more than 40%. The World Trade Organisation predicts that the world trade volume of goods could register a decrease of 9% in 2009, while UNO report, "The Situation and Perspectives of Global Economy" predicts a more accentuated decrease of 11%, the worst since the Great Depression of 1930.

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The Report of the United Nations Organisation for 2009 stipulates that the world nations will not coordinate their efforts in order to strive against the present crisis. If the governments' stimulation packages will be proved to be less effective and belated than they should be, the global economy could be diminished up to 0,4% in 2010.

The dramatic lowering of price for goods affected more those developing countries where the economy was dependent on the export of raw materials.

It is obvious that a series of anti-crisis measures able to support the entities may be taken at governmental level. Mention should be made about the following ones:

- re-invested profit tax exemption with a view to stimulating the investment and production and creating new jobs and, therefore, stimulating the demand;
- the reduction of the social insurance contributions: even if – at first sight - this measure seems to determine the tax reduction and a low budget income, it will stimulate the demand and/or job salvation, the consumption and production; it will impel the rhythm of the economic growth rendered by the dynamic benefits of such a measure that is going to counterpoise the static costs.

If it is to make reference to the entities, most of them feel the effects of the crisis. As measures, they calculated again the budget for this year and made short-term plans since the recession threw them into incertitude.

Besides the syncope of the financing system, the reduction on liquidity and the price modification affect more and more entities. They will not be able to fulfil adequately the obligations they have contracted before the crisis. The non-execution of the obligations calls the responsibility of the one who contracted them. The debtor has to repair the entire prejudice that the non-execution or the delayed execution of the obligations has done to the creditor – the one in whose favour the obligation should have been accomplished. Hence, by choosing not to fulfil the obligations they assumed in the past, the debtors might underwent a major risk and losses. Another condition that should be fulfilled in order to be in the presence of non-anticipation is the fact that the modification of the circumstances that determined the contractual imbalance could not have been anticipated at the date of acceptance of the obligations influenced later on. From this kind of perspective, it will be difficult to prove what types of risk could or should have been taken into account by the parties at the contract completion date, and especially what kind of impact of the above mentioned risks should have been anticipated. For example, the production cost variation is always an element taken into account when the supplier of equipments establishes the price, but should have a sudden cost increase of 40% out of the initial value been anticipated or not? Is it “an unforeseeable” change of the circumstances taken into account at the date when the price was established and the sale obligation was contracted?

The incorrect investment decisions and strategies represent the main reason that determines the insolvency of most of the entities.

The most frequent reasons that force entities into insolvency are the high organisational costs, but also the insufficient liquidities, and the anti-crisis solution flimsiness at the level of management.

Which are the most appropriate decisions that the management of the entity should take at a certain moment? If delayed, these decisions will take upon themselves higher costs.

Most of the entities adopted a series of anti-crisis measures that diminish the costs during the period of crisis as follows: the reduction of the budget for certain chapters, the reduction of the budget for all chapters, internal campaigns carried out with a view to involving the personnel in the reduction of costs, the reduction or intention of reduction in personnel, and the investment blockage.

As far as the decisions taken by the managers during the crisis are concerned, mention should be made about the following ones: the liquidity discharge, the co-operation between the

clients and suppliers, the implementation of cost reduction measures, and the reduction in personnel.

Most managers have the tendency to underestimate or overvalue the effects of the crisis. A study carried out by A.T. Kearney points out that a small number of entities are endowed with sustainable reorganisation strategies under crisis conditions.

How do entities solve the cost problem under crisis condition? The answer is the following one: in different ways, and depending upon the nationality of the respective entity. The partial results of a study in course carried out by the Austrian company M27 Consulting GmbH and specialists from Institut für Betriebswirtschaftslehre der Klein- und Mittelbetriebe in Vienna, with regard to the business practices and environment in Central and Eastern Europe, illustrate the different existing tendency from Romania, comparatively with other countries in the region, as far as the managers' decisions about cost reduction are concerned. In their attempt to reduce their costs without radically affecting their business, the Romanian managers often take decisions that will actually strongly affect the course of events of the entities, and several sectors of economy in few years.

The Romanian managers are interested only in immediate and simplistic cost reductions. They therefore prefer approaches with a low degree of sophistication: the reduction in personnel, salaries, and cost optimization through payments without legal contracts etc. In most of the situations, they are not aware or simply ignore other efficient and more mature alternatives from a managerial point of view, able to preserve the chances of success further on. Despite the fact that they confront with the same problem with regard to the costs, the managers in all other countries of Central and Eastern Europe under analysis (Bulgaria is an exception) take decisions according to methods of this millennium, "the analysis of essential competences" being included. It helps the process of selecting their future activities, and that of giving up to other ones.

Nevertheless, entities should adopt a strategic plan for a three-year minimum period of time at least. This plan should be based on the new market conditions and consumer psychology, and has to aim at the growth of the entity, and not to its "resistance" until the situation grows better.

The understanding of the consumer's needs, the development of products able to offer him low cost high performance, the interest in cost and productivity structure, and the main stress on innovation are the elements that should be taken into account for the next period of time.

"Lean" thinking means to approach the entire entity exclusively from the consumer's point of view, and the development of a supple system of immediate answer for market signals (coming from clients, suppliers and competitors). The logic consequence is the fact that the improvement of the performances comes either from the maximization of the effects of the processes that add values, or the minimization of the ones that cause losses, or both categories.

The internal processes of an entity should be analysed from the point of view of the added value and losses, that is to say, from the point of view of those actions and decisions that either bring value to the client, or increase the cost of production.

The entities that resist well during the crisis are those that register budget reductions through the long-term strategy they have adopted and cost reductions for the chapters that are about to disappear, and reassign their budget for the areas they intend to develop in the future.

Proposed measures:

- the cost adjustment in correlation with the dynamics of the activity of the entity and the business environment;
- cost optimization measures;
- the organization of the cost managerial accounting and their control with the support of the instrument boards.

The cost reduction is a priority for entities within the present economic context. It represents the first anti-crisis measure adopted by the managers. It is also necessary to pay more attention to the way in which these reductions are operated. If the cost reductions are chaotically administered,

they create the illusion of saving the entity; but this will be a short-term salvation; they could become the cause of a long-term instability beyond retrieve.

Cost reduction policies, if correctly applied, as a result of a rigorous analysis and by taking into account the specific character of the entity and the industry it involves, might determine the increase of the profit and limit the registered losses.

For example, the French group PSA Peugeot Citroen, that holds the second position in Europe in the top of producers of automobiles, want to reduce the fixed-cost level with 30%. This aspect is part of the reorganization initiative of the French company.

The fixed costs represent “non-elastic”, constant costs that do not depend directly proportional with the volume of activity or the sales value of the entity.

The fixed costs are generated by the consumption of the raw, human, informational and financial resources involved in the diverse activities of the entity with a view to obtaining income and benefits in accordance with the aims, policies and strategies of the entity.

Under favourable circumstances of business and economic growth, entities are interested especially in the achievement of the objectives related to the growth of the market quota and their income. They have in view development strategies with regard to the growth of investment in the modernization and acquisition of new depositing, sales and production capacity etc. This extension in the activities employed by the entity automatically generates an increase of the fixed costs related to the consumption of the new resources, too. Entities pay more attention to the fixed and variable cost reduction under the conditions of crisis, the business opportunity stagnation or restriction, and the obvious decrease registered as far as the income and financial sources are concerned. Hence, they take into account the objectives of maintaining the profitability and the financial equilibrium in an unstable and unforeseeable business environment.

The fixed cost identification, classification, reckoning and control should become a daily priority for all managers, no matter the entity they belong to. Cost analysis and control involve the awareness and understanding of the general characteristics of the activity carried out by the entity, but also the understanding of the interdependent relationship existing between the entity and the (economic, political, technological, social etc.) environment where activity is actually carried out.

The managerial accounting is the main source of information for fixed cost analysis and control.

Research methodology:

The following reference points should be taken into account with regard to the fixed cost analysis and efficient reduction:

- costs should be approached starting with the entity level (global approach) and then at the level of its components (types of activity and responsibility centres, types of expenses);
- the most important activities that are considered fixed cost generators should be identified; then, two fundamental options should be analysed:
 - o the activities are diminished and reorganised;
 - o the activities are totally eliminated;
- the resources that determine the highest rate of consumption within each responsibility centre should be also identified;
- the fixing of the methods of fixed cost reduction for each category of fixed expenses;
- the maintenance of the advantages of the cost reduction measures of long term effectiveness able to ensure the short, medium and long term competitiveness of the entity.

When the level of the production capacity under conditions of crisis is approached, managers should take into account, among other things, the descending spiral of demand and the effect upon the decisions about price fixing.

The descending spiral of demand does not represent something else but the continuous decrease in demand of the products of a certain entity when its unit costs grow higher and higher.

Let us take for example an entity "A". In order to calculate the cost of its product in 2009, we take into account the degree of the use of its production capacity stipulated in the general budget of 6.000 f.u. The cost of production that results is 8,50 m.u./f.u. (variable unit cost 6,75 m.u./f.u. + fixed cost of 1,75 m.u.f.u.). One of the clients receives another offer from a competitive entity, „B”: the price 8, 25 m.u./f.u. for 1.000 f.u.. The manager of the entity does not want to register losses and recover the costs in a long period of time, and „A” will therefore refuse to reduce the price up to the level established by competitor „B”. Hence, the entity is going to loose the contract with the above mentioned client. The loss of contract implies the fixed budgeted costs of 10.500 m.u. (1,75 m.u./f.u. x 6.000 f.u.) that should be distributed upon the quantity that remained: 5.000 f.u. at a quota of 2,10 m.u./f.u. (10.500/5.000).

At the same time, a client of entity "A" (1.500 f.u. of the budgeted production volume correspond to the above mentioned client) receives an offer from another competitor, "C": a price of 8,70 m.u./f.u.. The manager of entity "A" compares the price of the offer with the unit cost 8,85 m.u./f.u.. (6,75 m.u./f.u.+ 2,10 m.u./f.u.) that was calculated again, and refuses to make a new offer. This fact has repercussions of the contract: it is also lost. Of course, the production decreases again back as far as 3.500 f.u. In this case, the fixed cost per unit is 3,00 m.u./f.u. (10.500 m.u./3.500 f.u.).

The effect of fixed cost distribution upon the output in the general budget in continuous decrease presents itself as follows:

Table no. 1.

| Volume of activity stipulated in the budget f.u. | Fixed-unit cost m.u./f.u.. | Variable unit cost m.u./f.u. | Total unit cost m.u./f.u. |
|--|----------------------------|------------------------------|---------------------------|
| 6.000 | 1,75 | 6,75 | 8,50 |
| 5.000 | 2,10 | 6,75 | 8,85 |
| 3.500 | 3,00 | 6,75 | 9,75 |
| 2.000 | 5,25 | 6,75 | 12,00 |
| 1.000 | 10,50 | 6,75 | 17,25 |

The usage of the production capacity within the fixed-unit budgetary cost allows the avoidance of the need to calculate the unit costs again, when the estimated level of demand is modified because the fixed-cost distribution quota will be calculated again taking into account the available production capacity, and not the one that was used in order to satisfy the demand. The managers who automatically employ the registered unit costs with a view to establishing the level of price do not risk so much to provoke a descending spiral of demand when they base upon the indicators of the practical production capacity than in the situation when they employ the normal degree of the use of production capacity or the one stipulated in the general budget.

As a matter of fact, the variable expenses are correlated with the volume of the developed activity. If the level of activity registers a decrease, the cost that is obtained will be more reduced than the real expenses of the entity. A fixed-cost surplus that represents a "sub-activity cost" will therefore appear.

We make use of the above mentioned data and the result is the following one:

Table no. 2.

| Crt. No. | Explanations | Normal Activity | Real Activity | | | |
|----------|--------------------------------|-----------------|---------------|--------|--------|--------|
| | | | I | II | III | IV |
| 1 | Amount of products | 6.000 | 5.000 | 3.500 | 2.000 | 1.000 |
| 2 | Variable expenses | 40.500 | 33.750 | 23.625 | 13.500 | 6.750 |
| 3 | Fixed expenses | 10.500 | 10.500 | 10.500 | 10.500 | 10.500 |
| 4 | Total product expense | 51.000 | 44.250 | 34.125 | 24.000 | 17.250 |
| 5 | Total unit cost, out of which: | 8,50 | 8,85 | 9,75 | 12,00 | 17,25 |
| 5.a. | - variable cost | 6,75 | 6,75 | 6,75 | 6,75 | 6,75 |
| 5.b. | - fixed cost | 1,75 | 2,10 | 3,00 | 5,25 | 10,50 |

These data are then used in order to calculate the coefficient of rational imputation (K_R), the imputed fixed expenses (Chf_i), and the difference to be imputed (D_{IR}), as follows:

Table no. 3.

| Crt. No. | Explanations | I | II | III | IV |
|----------|--------------------------------------|------------------------------|------------------------------|------------------------------|------------------------------|
| 1. | $K_R = \frac{Qr}{Qn}$ | $\frac{5.000}{6.000} = 0,83$ | $\frac{3.500}{6.000} = 0,58$ | $\frac{2.000}{6.000} = 0,33$ | $\frac{1.000}{6.000} = 0,17$ |
| 2. | $Chf_i = Chf_r \times K_R$ | $10.500 \times 0,83 = 8.715$ | $10.500 \times 0,58 = 6.090$ | $10.500 \times 0,33 = 3.465$ | $10.500 \times 0,17 = 1.785$ |
| 3. | $D_{IR} = Chf - Chf_i \frac{Qr}{Qn}$ | + 1.785 | + 4.410 | + 7.035 | + 8.715 |

Conclusions

As we might see, the level of activity decreases comparatively with the normal one. The consequence is that the cost of production that will be obtained will be lower than the real expenses of the entity. Hence, there will be registered a fixed-expense surplus that will not be distributed. It actually represents a "sub-activity cost". This price is not included in the cost of the products, but directly into the result.

If the unit costs vary, the reasons for this situation should be looked into a modification of the conditions of exploitation and therefore a slideslip of the variable expenses. If the cost of the rational imputation is correctly established, the oversupply of another period of administration will allow to compensate the turning off that resulted in the case of underproduction. This deviation includes only the sum of the unincorporated fixed expenses, meaning the "sub-activity" cost of that period of administration.

Cost awareness represents a decisive factor that influences the decision making process or the future activity plan. The data analysis and registering with regard to the costs of activity in the past represents only a side of cost accounting. The managers are also concerned with the costs in the future since their level is the basis of the decision making process about supply and production, and for several price policies as well.

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