

## **Corporate Governance and Strategic Cost Management**

### **---- A perspective from China**

Good morning everyone, I am excited to be here today. I would like to start my speech today with a brief self-introduction.

I am currently the President of University of International Business and Economics and a professor in Accounting at the Business School. I am also a fellow member of the Association of Chartered Certified Accountants. I am interested in many research topics within the wider area of accounting and financial management including management accounting, strategy and corporate governance. As I am an academic as well as the independent director of several listed companies in China for more than 20 years, I have been dealing with the issue of cost management from both a theoretical and a practical perspective for a very long time. It is a great pleasure to be able to share some of my thoughts that have been developed over the years with you today.

The topic of My presentation today is corporate governance and strategic cost management, a perspective from China. It consists of three parts. Firstly, I will begin by briefly discussing the challenges Chinese firms have met today with their application of strategic cost management. Secondly, I will present a framework to outline the important factors that I believe have strong influence on companies' cost management practices. Thirdly, I would like to use three cases that are drawn from the strategic cost management practices by Chinese companies to support my opinion.

Strategic cost management has been an essential area of interest both in academia and in practical world since it was first introduced by Shank in late 1980s. While formulating the strategy for the accomplishment of organizational overall objectives, different cost driver should be clearly identified. Identification of key cost drivers help companies to focus on key activities that will constitute almost 90% of the total costs. Strategic cost management stresses the importance of an external focus and the examination of the entire

value chain. This implies that organization should be installing appropriate framework of strategic cost management to reduce its costs in key areas on which the success of organization is heavily dependent. Many companies have sought to adopt it when it was introduced to China in the 1990s. However, companies have encountered several problems in this process.

Firstly, in most firms, strategic cost management are only adopted after many important decisions, such as the strategy of the firm, the product's competitive positioning, the design of products, technology used in production, product's specifications, materials, or the cost structure. These decisions have a stronger influence on product costs as changes that are led to by strategic cost management in a latter stage are difficult to be accepted and implemented. Cost drivers can be identified, but the changes are difficult and expensive to be implemented. When the real changes are difficult to come through, strategic cost management becomes a fancy word used by CFOs to impress the stake holders, and sometimes a gaming exercise for different departments to compete for resources.

Secondly, I found that cost reduction is more effective and efficient when it is achieved in the company of more fundamental organizational changes rather than the changes led by cost management alone, such as the change in organizational structure, a insightful choice of strategy, the appointment of resourceful and powerful leaders. Empirical evidence suggests that cost-cutters that have a myopia view and a narrow focus on cost tend to grow slowly than those companies which successfully grow both their top and bottom lines by adopting more fundamental changes. I will further illustrate this point when discuss the two cases later.

Thirdly, cost management inevitably requires the support from employees. Managers who are seeking to push forward the cost reduction programmes are faced with the motivation issue, how to make sure that employees' interests are aligned with the companies', how to better control employees without stifling their initiatives, how to better evaluate their performance without leading to dysfunctional behavior. In other words, cost reduction cannot be achieved simply by focusing on cost alone. from what I have witnessed an independent directors and a researcher, Cost can be more efficiently and effectively managed when the attentions are directed on to a more macro level

and when more fundamental changes than cost reduction ones are introduced to the companies.

In the next part, I would like to talk about the critical determinants of costs in Chinese firms.

It is argued that the import cost related decisions are made at three different levels, BOD and top management level, departmental management level and accounting level.

The BOD and top management level: this is the most macro and significant level of cost management. the BOD and the top management it appoints make the most important decision in a firm which have significant bearings on product costs. It is argued that the basis of all decisions in a company is its capital structure. The capital structure of a company determines its the corporate governance structure. Effective corporate governance can reduce the risk faced by the company, improve decision-making effectiveness, increase the projects' operation efficiency, and improve the quality of senior management and employees to achieve the maximization of shareholders values. The objective of value maximization in capital market can be achieved in higher performance in the product market. In other words, the effective corporate governance structure will improve product quality, and reduce the cost of product. Next, I will discuss in detail the specific mechanisms through which a firm's corporate governance influence its cost management activities.

Corporate governance structure has significant influence over both the BOD decisions and top management decisions. These decisions include the company strategy, technology level, the investment in fixed and intangible assets, office location, and the hiring as well as the remuneration of Top management. While the decisions of the top management including CEO, CFO, CMO consist of the organizational structure of the company, the execution plan of strategies, performance evaluation and motivation scheme for employees, product design and development, marketing and sales channel. All these decisions have important bearings on the overall costs of product. The strategy of a firm set the tone of its cost management activities. The level of technology adopted in the manufacturing process determines the cost structure of the products and affects the fixed portion of the overall product cost. The choice of office and factory location has a strong influence on the price of human capital and raw materials, also affecting the fixed cost of products. Meanwhile, leadership, execution ability of Top management and

their decision making effectiveness determines whether the strategy can be implemented properly, the appropriate product design and marketing plan can be chosen, a coherent management control system can be adopted. All these factors have strong influences over the product costs.

2. Department managers level: this is the micro level of the cost management, mainly refers to the management of manufacturing process and supply chain. This is to make sure that the whole manufacturing processes can be carried out smoothly and efficiently. This includes the supervision of production line, the maintenance of machines, product quality assurance, the purchase and logistic management, and related information collection. These management activities at the department manager level have an influence on product costs as well, however they do not have a key role in determining the cost as the first level factors do. For example, which supplier to choose inevitably affects product costs. The manager of the purchase department who are responsible have to be properly controlled and motivated to make the best decisions that are aligned with the interests of the firm.

3. Accounting levels: this refers to accounting calculation and analysis of product cost based on the information collected at the previous level. The management activities at this level provides descriptive data of product cost along the supply chain, compare the target costs and actual costs, identify the discrepancies, conduct variance analysis and point out the direction of improvement. Such analysis is usually provided by the financial department. It provides an overall picture of the different compositions of product cost and illustrates how efficient each chain is. It is helpful in providing directions for future improvements, therefore affecting product costs to some extent. Apparently, this level's analysis is not as important as the first two levels.

To summarize, the key point I made above is that corporate governance has a significant impact on product costs by influencing the choice and remuneration of top management and the related decisions made by BOD and top management. Cost management should not be conducted with a narrow focus on cost alone. Strategies, organizational structure, motivation plans, sales channels, leadership and execution ability of the leaders have all to be managed in concert to ensure effective cost management. Next, I am going to use the empirical materials I obtained from three manufacturing companies in china to further illustrate these points.

The first case I would like to discuss is a home appliance manufacturing company in China, the Haier Group. It was founded in 1984, It has been transformed from originally a small collective refrigerator plant on the verge of bankruptcy, to the world's No.1 brand of consumer appliances over the past 26 years. It is an international group which has more than 70,000 employees around the globe and realizes a turnover of 13.57 billion Pound in 2010.

Haier has been able to achieve effective cost management through a revolution of the system of the companies' strategy, organizational structure, performance evaluation and incentive system and the information system. The changes have to take place at the same time to make sure that these different components of this whole new system operate in concert and succeed in aligning the interests of the firm and those of the employees'. In the next part I will introduce the management accounting innovation that Haier adopted to increase its international competency and both the top line and the bottom line items

## I. Strategy

Haier has a history of quick adjustments to its corporate strategies to ensure that its strategy adapts to the changing environment that Haier is embedded in. Identifying an appropriate Strategy entails an overall assessment of the firms' position in the market and its competitive advantages. It helps to set the tone of and identify the directions for cost management. It is the first step in the overall system of revolution.

Then in 21<sup>st</sup> century, with the development of information technology and global economic integration, Haier reinforced its strategy as satisfying the personalized needs of customers in a short time. Such a strategy requires a large-scale customization rather than massive production. Under this strategy, it is believed that cost reduction is achieved through the overall increase in efficiency and a more effective motivation scheme.

## 2. Organizational structure and performance evaluation

To meet with the challenges presented by the changing environment, Haier restructured the entire business into more than 4100 self managed units which are named zzjyt. In Chinese it means the self-managed operational units. Each ZZJYT covers the entire value chain. It has one or two members from each of

the original functional departments. ZZJYT is created to ensure that each major customer has a unit that is responsible for catering his needs.

As you can see from this graph, in a traditional organizational, managers give orders which are then carried out by employees. on one side, this increases the distance between the decision makers and customers. While on the other side, this creates dysfunctional behavior as employees may not regard carrying out these orders as serving their best interests. It is argued that the traditional hierarchical structure is not fit with the strategy which requires satisfying personalized demands of customers in a short time period. Therefore, the new organizational structure of haier dictates that employees who deal with customers directly are empowered to make all decisions. Managers are only there to support them and provide resources. Customers are categorized by locations or types, each homogeneous group of customer is managed by one specific ZZJYT. Such an organizational structure is called an invert triangle in haier.

By dissolving a company with over 70,000 people into 4100 zzjyts, a real market is created within the firm. Each zzjyt operates like an independent company. It has to identify the demands of the customer it is responsible for and make sure that its members from product and manufacturing divisions can create the corresponding products to satisfy such needs and the customized products can be efficiently produced. Each ZZJYT has its own Income statement, against which its performance will be evaluated. The Sales is the income a zzjyt brought in while costs are all the costs incurred within the zzjyt including materials, production, sales, marketing as well as the opportunity cost. For example, only sales accompanied by cash inflow are recorded as an income in the PL while over stock is charged at 1RMB per unit per day.

The residual value calculated by subtracting the company's profit from net income calculated in the zzjyt's profit and loss account belongs to the zzjyt members. They are free to share this residual income as part of their bonus. In reality, members of a well performing zzjyt can have his or her salary tripled under the new scheme. In this way, employees' interests are aligned with those of the organization's.

This new form of organizational structure contributes immensely to the overall cost management. Firstly, by attributing all costs into different zzjyt and gauging costs with the income of the zzjyt, it helps to clarify which cost is more effective in producing profits. As a result, the costs that are unable to produce

value for customers can be avoided. In this respect, cost management in zzjyt can be considered as the strategic cost management in a vertical form. Secondly, by dividing the entire work group into 4100 zzjyts, the new organizational structure enables the HR manager to identify the unnecessary personnel. By making them redundant, labour cost and overhead cost can be saved accordingly. Lastly and most importantly, zzjyt decreases the dysfunctional behavior of employees. as zzjyt aligns the interests of employees with those of the company's, costs saving and cutting become the concern of every member of zzjyt. The higher the costs, the lower the residual income employees are entitled to. As a result, employees will be self motivated to be involved in the cost management activities. More importantly, such cost reduction activities will be conducted at the expense of product and service quality. Employees within zzjyt understand that it is in their best interests and the firm's as well to improve both the top line and bottom line items at the same time.

To summarize, the effective corporate governance structure at Haier gives rise to a functioning board of directors of Haier Group which is able to adjust its company strategy to adapt to the changing environment. The top management chosen by the BOD is then able to innovate its organizational structure, performance evaluation and incentive system to ensure that its strategy can be implemented successfully. Cost reduction is rendered possible without jeopardizing the interests of customers with such new organizational structure. Top line and bottom line items are improved at the same time. Along these lines, Haier has become the largest home alliance manufacturer worldwide with a market share of 6.1%. Its compounded annual growth rate of sales over the past 5 years is 35% while its recent two years growth rate of profit is 67% and 55%. Again this further supports my argument that the cost management activities are most effective when accompanying some more fundamental changes within a company. An effective corporate governance structure is the basis of and the accelerator of such fundamental changes.

The second case I would like to discuss here is an air conditioner producer, Gree Electronic Alliances, which was established in 1991, It is now the world's largest specialized air conditioner manufacturer integrating R&D, manufacture, sales and service. In 2009, its annual sales revenue reached 4.25 billion pounds. It has been ranked "Top 100 Chinese Listed Companies" according to Fortune magazine in consecutive eight years. It is regarded as one the most efficient organizations in China.

Its products are distributed to more than 100 countries and regions in the world and it has more than 70 million users worldwide. Gree's sales volume and market share have been the largest among Chinese air conditioner manufacturers for more than 15 years while; its sales of residential air conditioner has been the largest worldwide since 2005,.

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Similar to Haier, Gree's success in cost reduction and growth in sales are accompanied by more fundamental changes within the organization. Such changes are supported by its effective board of directors and are enabled by its dispersed ownership structure. In Gree's case, the fundamental change is a revolution in sales model led by its CEO Ms. Dong.

Before appointed as CEO in 2001, Ms. Dong is the best saleswoman in Gree's history and she had been in charge of the sales department. Her outstanding leadership, execution ability and original insight have fueled Gree's innovation in sales model which further makes possible its cost management activities. Therefore in Gree's case the appointment of top management has a significant influence on the cost management activities.

While most of the electronic appliances producers use wholesalers and supermarket as their main sales channels, Gree took a different approach by establishing franchised stores all over China. Gree's CEO Dong has dedicated to the nurturing company-franchise dealer relationship. Gree has a off season financing policy which entails Gree providing free financing service and a certain percentage of profit out of its own pocket to its dealer. Gree also cuts a generous slice of profits for its delaers at the end of each year. Such innovative sales strategy greatly influences the producer-dealer relationship and improves the loyalty of dealers. In China, it is ordinary for the wholesaler and supermarkets to have a stronger bargaining power than the producers. However Gree's innovative sales model has greatly improved its market position and granted Gree the stronger bargaining power.

Through the construction of Gree's franchised stores and development of its dealership, Gree opened more than 10,000 Gree stores around the globe. The Innovative sales model has reinforced Gree's differentiator strategy. Such innovation increases the information flow rates and reducing inventory turnover. Therefore the cost management accompanied by this sales model innovation is able to reduce the cost of product and the overhead cost, improve



the efficiency of working capital, decrease operating cost and increase shareholders' value.

As shown in the table here, Gree has achieved a higher gross profit ratio and a much lower cost ratio compared with its competitors. Its cash conversion cycle was minus 45 days in 2009. The higher proportion of sales costs are more than compensated by the increase in efficiency and the decrease in all other costs.

To summarize, In China we found that the most effective cost management is achieved while accompanied by other fundamental changes in the company. It is argued that cost management cannot be approached with a narrow focus on cost. Corporate governance structure and effective board of directors have a significant impact on important cost related decisions. For a firm's cost management measures to take effect, many other aspects of the firm's management system have to be reshaped by BOD and top management. This concludes my presentation today. Please feel free to ask any questions.