

# THE IMPORTANCE OF KNOWING THE ENTERPRISE'S HIDDEN COSTS

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*The cost is one of the most important indicators at the level of the enterprise. The exact determination of the cost presents a special importance for appreciating the performances of the company. Disfunctions appear in the activity of any enterprise and their correction actions generate hidden costs. The hidden costs are a little or at all identified by the traditional systems of management accounting. The paper proposes the presentation of hidden costs which appear in the enterprise's activity, of the evaluation method, as well as the presentation of some opinions regarding the reduction possibilities of hidden costs.*

*Keywords: hidden costs, visible costs, disfunction, decision*

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## **Introduction**

The base function of the economic informational system within the enterprise is to produce information on the basis of which decisions are adopted. The accounting offers the greater part of this information, being one of the principal components of the economic informational system. In the process of elaboration of decisions, the information regarding the cost has an important role, the managers being interested not only in the enterprise's former costs but also in the future costs. The management accounting offers information regarding the costs level but its role is not reduced only to costs calculation, but it has to allow to the decision factors within the enterprise to act for their control.

An enterprise is considered performant if it succeeds in creating value for its shareholders. Between costs and performance, there is a direct relation, a high level of costs has as effect a low level of performance and inversely. The performance analysis is not sufficient, the managers having to administrate the performance. The information regarding the cost influences the elaboration process of economic-financial decisions within the enterprise on various ways: the relation cost-price, relation cost-profit, relation cost-economic efficiency.

We cannot dimension the company's performance if we don't succeed in the precise determination of costs generated by the enterprise's activity. Those who take decisions within the enterprise don't have the same degree of control over all costs. Thus, resulting the necessity that the decision factors identify the costs they can influence and the costs they cannot influence.

The limited character of available resources and the desire of managers and shareholders to increase the enterprise's financial performance, enhance the need to know more precisely the costs level.

According to the opinion of professors Kaplan and Atkinson, the information regarding the costs is important for managers for at least three reasons<sup>588</sup>:

- on the cost basis, there are decided the product's purchase, manufacture or abandoning and it is influenced the nature of relation with clients;
- the costs can represent a base for prices substantiation;

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588 Kaplan, R.S.; Atkinson, A.A., Advanced Management Accounting, third edition, Prentice Hall International, 1998, p. 222.

- through the cost analysis, there are identified the needs of improvement of products, design or production process.

### **What are hidden costs?**

The traditional management accounting centred upon the registration and pursuit of costs supported by the enterprise for the achievement of its economic function. In the last decades, there was a great emphasis on the enterprise's social function that generated a series of hidden costs, unexplained by the traditional systems of management accounting.

The professor Henri Savall from ISEOR (The Social-Economic Institute of Organisations and Enterprises) from Lyon, proposed and developed the hidden cost-performance method. The method was experienced in various areas of activity and in companies of different sizes, having between 20 and 18.000 employees.

A cost is considered hidden if it doesn't appear explicitly in the information systems of the enterprise. In exchange, the visible costs are those which are detected by these systems.

The visible costs present three fundamental characteristics:

- have precise denominations, normalized and recognized;
- are analysed after known and precise rules;
- are the object of a regular supervision which has as purpose the checking of their evolution in comparison with a certain settled objective.

H. Savall and V. Zardet consider that any element of the cost that lacks one of the three properties is by definition a "hidden cost". Other authors consider that the particularity of hidden costs is that they are engaged out of the official procedure although achieving considerable levels.

The enterprise's activity is permanently perturbed by the disfunctions appearance. The enterprise react to correct these disfunctions. These actions of correction generate some costs for the enterprise: losses due to the functioning at an inferior level to that programed, additional wage expenses for the employees that replace the absent ones, overconsumption of energy, additional external services, wastes e.t.c. Thus, the hidden costs represent the monetary expression of correction activities of disfunctions.

The costs due to disfunctions represent the difference between real functioning and the ideal functioning of the enterprise. The concept of ideal functioning of the enterprise refers to achievement of objectives taking into consideration the constraints and limits of social, psychological and physical nature of the employees, considered not only individually but also collectively.

In the specialty literature, the cost is dealt with not only as an expression of factors consumption in order to produce something, but also as sacrificed chance, as a renunciation cost to something else. We can mention also in the range of hidden costs „the postponed occasions costs". These represent the profit lost as a result of nonrealization of a product, service or work at the convenient time.

The costs and hidden performances are in relation of reciprocal determination thus: an increasing cost means low performance, and a low cost means the increasing of enterprise's performance.

There are known phenomena at the origin of hidden costs. The hidden costs are supported from results and are not isolated as such, not being related to the phenomenon that generated them. For instance, the quality low cost in the manufacture process has as consequence the increase of return cost of bad products or the increase of control costs.

For the disfunctions correction, the enterprise supports some additional costs. These are related to an additional human activity or to an additional consumption of material resources. Thus, the enterprise consumes additional material resources for the disfunctions correction, and its staff is obliged to develop additional activities which they wouldn't have developed in the case of normal functioning of the enterprise.

H. Savall and V. Zardet consider that there are five disfunctions<sup>589</sup> generated by anomalies, perturbations or deviations between ideal functioning and that stated by the enterprise: absenteeism, work accidents, staff rotation, quality defects and diminution of direct productivity. The disfunctions may enhance hidden costs in six organizational domains: time management, work conditions, work organization, implementation of the strategy, integrated training and communication-coordination-pursuit of objectives.

The hidden costs divide into two categories. The first category is formed of hidden costs that are comprised in visible costs. These are effective costs and correspond to the real losses of the enterprise. The second category is formed of hidden costs which are not comprised in the visible costs. These are also called potential costs and are represented by absence of production resulted from disfunctions. These are virtual costs, corresponding to a subactivity.

The hidden costs may have also external causes as: strikes of public services or their adverse functioning, the justice's incapacity to solve in time the commercial litigations.

### Hidden costs evaluation

Hidden costs evaluation is made extra bookkeeping and it is based on the very precise determination of disfunctions and of their consequences, from inside by those with full knowledge of the case.

For the hidden costs evaluation, we have in view five components: excess salaries, overtimes, overconsumption, nonproduction, noncreation of potential.

Excess salaries refer to wage deviations which appear when the absent employee is replaced by another with a bigger wage or by additional staff. Also, excess salaries are a consequence of lack of staff and time spend for the errors correction of some employees.

Overtimes correspond to the correction activities as formation of a substitute, useless activities deployed by some employees, activities of searching information, inefficient equipments.

Overconsumption represents the additional consumption of material resources (energy, materials and other consumptions which wouldn't be necessary if the company hadn't disfunctions).

Nonproduction analyses the absence of activity caused by events as equipments flaw, work accidents, strikes. This component corresponds to lost occasions to realize and sell a product.

Noncreation of potential represents the cost in human times of immaterial investment actions at which the enterprise has been obliged to give up temporarily, as its decision factors were concerned with disfunctions correction and hadn't enough time to look after strategy. The delay of an investment can lead to rentability compromising, and in this case we deal with a strategic hidden cost.

Hidden costs evaluation can be made on the model<sup>590</sup> from the Table no.1.

Indicators	Excess salaries (1)	Overtimes (2)	Over-consumption (3)	Non-production (4)	Non-creation of potential (5)	Total hidden costs (1+2+3+4+5)
Absenteism						
Work accident						
Staff rotation						
Quality of products						
Deviations						

589 Savall, H.; Zardet, V., Maitriser les couts et les performances caches, Economica, Paris, 1995, p. 127-132.

590 Savall, H., Les couts caches et l'analyse socio-economique des organizations, Encyclopedie de gestion, Economica, Paris, 1997, p. 715.

from productivity						
TOTAL						
Economic concepts	Historical costs			Opportunity costs		
Accounting concepts	Overexpenses			Non-products		

**Table no.1. Model hidden costs evaluation of the enterprise**

**Source:** Savall, H., -, „Les coûts cachés et l’analyse socio-économique des organisations”, Encyclopédie de Gestion, Economica, Paris, 1997, p.720.

In the case of absenteeism, the enterprise pays not only the wages of absent employees but also those of their substitutes. We have to take into consideration the fact that the persons called to replace the absent ones are without experience, fact that generates losses at the work place and the carrying out of some work tasks behind time. Beside the absents and substitutes’ wage, the enterprise has to support also the wage of the person that instructs the substitute.

The quality faults of products have to be remedied, and this activity implies additional work time, wages and material resources consumption.

### Conclusions

The financial performance of the enterprise is improved when it succeeds in reducing the proportions of its disfunctions. This performance, obtained by diminution of hidden costs is not reflected separately from accountancy and thus, it is called hidden performance. The hidden costs reduction offers to the enterprise additional resources that can be used for development or for survival on the market.

The knowledge of all enterprise’s costs is usefull for those who decide in the enterprise not only for its analysis but also for the performance administration. In present economic conditions, a rigorous control is imposed over all categories of resources that the enterprise disposes of.

The world-wide studies demonstrated that by their size, the hidden costs are important for companies, aspect that lead to the finding of solutions for their diminution.

For the reduction of hidden costs level, it is necessary to act over the causes of disfunctions which appear within the enterprise. These causes are characterized by diversity and complexity. The hidden costs evaluation is influenced by the enterprise’s dimension, by the complexity of its activity and by the organization method of the accounting informational system.

In the reduction of hidden costs an important role is due to the enterprise’s staff. Each employee of the enterprise is a possible generator of hidden costs, as he can create disfunctions within the enterprise.

The enterprise has to follow not only the attainment of economic-financial performance but also of the social and environmental one. The improvement of costs-hidden performances method must be one of the objectives of administration accountancy. The costs-hidden performances method is difficult to put into practice despite the advantages offered. The determination of disfunctions and costs generated by these is difficult and implies other costs.

In our opinion, the hidden costs of the enterprise can be greatly reduced but not totally eliminated. Thus, the enterprise has the possibility to eliminate the greater part of its disfunctions, but it couldn’t act over the external causes generating hidden costs as the public services strikes or the difficult functioning of justice system.

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