Profit Centers

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profit center

- When a responsibility center’s financial **performance** is measured in terms of **profit**
  - (i.e., by the difference between the revenues and expenses),
- the **center** is called a ***profit center.***
- **Profit** is a particularly **useful** performance **measure**
  - since it allows **senior management** to use one **comprehensive** indicator rather than **several**
  - (some of which may be pointing in different directions)

General Considerations

- A ***functional organization*** is one in which each principal manufacturing or marketing function is **performed**
  - by a **separate** organization **unit**.
- When such an organization is **converted** to one in which each major unit is **responsible** for both the **manufacture** and the **marketing**,
  - the process is termed ***divisionalization***
- companies create **business units**
  - because they have decided to **delegate** more **authority** to operating managers

Conditions for Delegating Profit Responsibility

- Many **management decisions** involve **proposals** to increase **expenses**
  - with the **expectation** of an even greater **increase** in **sales revenue**.
- Such decisions are said to **involve expense/revenue trade-offs**
  - **Additional advertising expense** is an **example**.
- Before it is safe to delegate such a trade-off decision to a lower level manager,
- **two conditions** should **exist**:

two conditions

- 1. The **manager** should have **access** to the ***relevant information*** needed for making such a **decision**.
- 2. There should be some way to **measure** the **effectiveness** of the **trade-offs** the manager has made

conditions

- A major step in creating profit centers is to **determine** the **lowest** point in an **organization**
  - where these two **conditions prevail**.
- All **responsibility** centers fit **into** a **continuum** ranging
  - from those thatvclearly should be profit centers
  - to those that clearly should not.
- **Management** must decide
  - whether the **advantages** of giving profit **responsibility offset** the **disadvantages**
- As with all management control system design choices,
  - there is no clear line of demarcation

Prevalence of Profit Centers

- most **companies** in the **United States** remained **functionally** organized
  - **until** after the **end of World War II.**
- Since that time many major U.S. corporations
  - have **divisionalized** and have **decentralized** profit **responsibility** at the **business unit** level.
- Alfréd P. Sloan (General Motors) and Ralph J. Cordiner (General Electric)
  - have documented the philosophy of divisionalization and profit decentralization.
- In a survey of *Fortune* 1,000 companies
  - in the United States, of the 638 usable responses,
  - 93 percent were from companies that included two or more profit centers

Advantages of Profit Centers

- The ***quality*** of **decisions** may **improve**
  - because they are being made by managers **closest** to the **point** of **decision**.
- The ***speed*** of operating **decisions** may be **increased**
- since they do not have to be referred to corporate headquarters.

- **Headquarters management**, *relieved of day-to-day decision making,* can **concentrate** on **broader** issues.

Advantages of Profit Centers

- **Managers**, subject to fewer corporate restraints,
  - are **freer** to use their **imagination** *and **initiative**.*

- Because **profit centers** are similar to **independent companies**,
  - they provide an excellent ***training** ground* for **gener**al **management**.
- Their **managers** gain **experience** in managing **all functional** areas,
- and **upper management** gains the **opportunity** to **evaluate** their potential for **higher-level jobs**

Advantages of Profit Centers

- ***Profit consciousness*** is **enhanced** since managers who are **responsible** for profits will constantly seek ways to increase them.
  - (a manager responsible for marketing activities, for example, will tend to authorize promotion expenditures that increase sales,
  - whereas a manager responsible for profits will be motivated to make promotion expenditures that increase profits.)
- **Profit centers** provide top management with **ready-made** information on the ***profitability*** *of the company's individual components.*
  Because their **output** is so **readily measured**,
  - profit centers are particularly **responsive** to **pressures** to improve *their* ***competitive performance***

Difficulties with Profit Centers

- **Decentralized decision** making will **force top** management
  - to **rely more** on **management** control reports than on personal knowledge of an operation,
  - **entailing** some ***loss*** *of* ***control.***
- If **headquarters management** is more capable or **better informed** than the **average** profit **center manager**,
  - the *quality* of decisions made at the unit level may be ***reduced.***

Difficulties with Profit Centers

- ***Friction*** may **increase** because of **arguments** over the **appropriate transfer price**,
  - the assignment of common costs, and the credit for revenues that were formerly generated jointly by two or more business units working together.
- **Organization** units that once **cooperated** as functional units may now be in ***competition*** with one another.
  - An **increase** in **profits** for one manager may **mean** a **decrease** for another.
  - In such **situations**, a **manager** may **fail** to **refer sales** leads to another **business** unit **better qualified** to pursue them;
  - may **hoard personnel** or **equipment** that, from the overall company standpoint, would be **better off** used **in another unit**;
  - or may make **production decisions** that have **undesirable cost** consequences for other units

Difficulties with Profit Centers

- **Divisionalization** may impose ***additional costs***
  - because of the additional management, staff personnel,
  - and record keeping required, and
  - may lead to task redundancies at each profit center
- **Competent *general managers*** may **not exist** in a **functional organization**
  - because there may not have been sufficient opportunities for them to develop general management competence

Difficulties with Profit Centers

- There may be **too much emphasis** on ***short-run profitability*** at the expense of long-run profitability.
- In the **desire** to report high **current profits**,
  - the profit center manager may **skimp** on **R&D**, **training programs**, or **maintenance.**
- This tendency is especially prevalent when the turnover of profit center managers is relatively high.
- In these **circumstances**, **managers** may have good reason to **believe** that their actions
- may not **affect profitability** until after they have **moved** to **other jobs**.
  There is no **completely satisfactory** system for
  - **ensuring** that **optimizing** the **profits** of each **individual profit** center
  - will ***optimize*** *the* ***profits*** *of the* ***company*** *as a* ***whole***

Business Units as Profit Centers

Business Units as Profit Centers

- **Most business** units are **created** as profit **centers** since managers in charge of such units typically **control**
  - **product** development, **manufacturing**, and **marketing** resources.
- These **managers** are in a **position** to **influence revenues** and **costs** and
  - can be held accountable for the "bottom line."
- a business **unit manager's authority** may be constrained
- in various ways,
  - which ought to be **reflected** in a profit **center's** design and **operation**.

Constraints on Business Unit Authority

- To realize **fully** the **benefits** of the profit center concept,
- the **business** unit manager would **have** to be as **autonomous**
  - as the president of an independent company.
- such **autonomy** is not **feasible**
- If a company were **divided** into completely **independent units**,
  - the organization would **lose** the **advantages** of **size** and **synergy**.

Constraints on Business Unit Authority

- in **delegating** to **business unit** management
  - all the **authority** that the board of directors has given to the **CEO**, senior management would be **abdicating** its **own responsibility**.
- business **unit structures**
  - represent **trade-offs** between business unit autonomy and corporate constraints
- The **effectiveness** of a business unit organization is largely **dependent**
  - on **how well** these **trade-offs** are **made**

Constraints from Other Business Units

- **One** of the main **problems** occurs when business units must **deal** with one **another**.
- It is **useful** to think of managing a profit **center**
- in terms of **control** over three **types** of **decisions**:

Constraints from Other Business Units

- (1) the **product** decision
  - (what goods or services to make and sell),
- (2) the **marketing** decision
  - (how, where, and for how much are these goods or services to be sold?), and
- (3) the **procurement** or **sourcing** decision
  - (how to obtain or manufacture the goods or services).

Constraints from Other Business Units

- If a business **unit** manager **Controls** all **three activities**,
  - there is usually no **difficulty** in assigning profit responsibility and measuring performance.
- the **greater** the degree of **integration** within a company,
- the **more difficult** it becomes to assign **responsibility** to a **single** profit **center**
  - for all three activities in a given product line;

Constraints from Corporate Management

The **constraints** imposed by corporate management can be grouped into **three types**:

- (1) those resulting from **strategic considerations**,
- (2) those resulting because **uniformity is required**, and
- (3) those resulting from the **economies** of **centralization**.

Constraints from Corporate Management

- Most **companies** retain certain **decisions**, especially **financial** decisions,
  - at the **corporate** level, at least for **domestic** activities.
- one of the **major constraints** on **business units**
  - results from corporate control over new **investments**.
- Business units must **compete** with one another for a share of the **available funds**

Constraints from Corporate Management

- Thus, a **business** unit **could** find its **expansion** plans thwarted
- because **another** unit has **convinced** senior management that it has a **more attractive** program.
- Corporate **management** also **imposes** other **constraints**.
  - Each business unit has a "**charter**" that specifies
    - the marketing and/or production activities that it is permitted to undertake, and
    - it must refrain from operating beyond its charter,
    - even though it sees profit opportunities in doing so.
- Also, the **maintenance** of the proper corporate image may **require constraints**
  - on the **quality** of **products** or on **public relations** activities

Constraints from Corporate Management

- Companies impose some constraints on business units because of the necessity for **uniformity**.
- One constraint is that business units must conform
  - to corporate **accounting** and **management** control **systems**.
- This constraint is especially **troublesome** for **units** that have been **acquired** from another **company**
  - and that have been **accustomed** to using **different systems**.

uniformity

- **Corporate headquarters** may also impose **uniform**
- pay and other **personnel policies**
- uniform policies on **ethics**,
- **vendor selection**,
- **computers** and **communication** equipment,
- even the design of the business unit’s letterhead

corporate constraints

- corporate constraints **do not** cause **severe** problems in a **decentralized** structure
  - as long as they are dealt with **explicitly**;
- business **unit management** should **understand**
  - the **necessity** for most constraints
  - and should **accept** them with **good grace**.
- The **major problems** seem to revolve
  - around **corporate service activities**.
- Often business units believe (sometimes rightly) that
  - they can obtain such services at less expense from an outside source.

Other Profit Centers

(Examples of profit centers, other than business units)

Functional Units

- Multibusiness companies are typically divided into business units,
  - each of which is treated as an **independent profit-generating unit**.
- the **subunits** within these business units, however,
  - may be **functionally organized**
- It is sometimes desirable to constitute one or more of the functional units
  - e.g., **marketing, manufacturing, and service operations**
- as profit centers

Functional Units

- There is no **guiding principle**
  - declaring that certain types of units are inherently profit centers and others are not
- Management's decision as to **whether** a given unit **should** be a **profit center**
- is based on the amount of ***influence***
  - (even if not total control)
- The unit's **manager exercises** over the activities that **affect** the **bottom line**

Marketing

- A **marketing** activity can be turned into a **profit center**
  - by **charging** it with the **cost** of the **products sold**.

- This **transfer price** provides the marketing manager
- with the **relevant information** to make the optimum revenue/cost trade-offs,
- and the **standard** practice of **measuring** a profit center’s manager by the center’s profitability
  - provides a check on how well these trade-offs have been made.

Marketing

- The **transfer price charged** to the profit center should be based on the **standard cost**,
  - rather than the actual cost, of the products being sold.
- Using a **standard** cost **base**
- **separates** the **marketing cost performance** from that of the **manufacturing** cost performance,
  - which is affected by changes in the levels of efficiency that are beyond the control of the marketing manager.

Marketing

- **When should a marketing activity be given profit responsibility?**
  - When the marketing manager is in the **best position** to make the **principal cost/revenue trade-offs**.
- **This** often **occurs** where different conditions exist
- in different **geographical** a**reas**
  - for example, a *foreign marketing activity.*

cost/revenue trade-offs

- In such an **activity**,
- it may be difficult to control **centrally** such **decisions** as
  - how to **market** a product;
  - how to **set** the **price**;
  - how **much** to spend **on** sales **promotion**,
  - when to spend it, and on **which media**;
  - how to train **salespeople** or **dealers**;
  - where and when to **establish** new **dealers**

Manufacturing

- The **manufacturing** activity is usually an **expense center**,
  - with the **management** being judged on performance **versus standard costs** and **overhead budgets**
- This measure can **cause problems**,
  - since it does not necessarily **indicate**
  - how **well** the manager is **performing** all aspects of his **job**.

Examples

- A **manager** may **skimp** on quality **control**,
  - **shipping** products of **inferior** quality in order to **obtain standard** cost **credit**.
- A **manager** may be **reluctant** to interrupt **production schedules**
  - in order to produce a rush order to accommodate a customer.
- A manager who is **measured** against **standards**
  - may **lack** the **incentive** to manufacture **products** that are **difficult** to **produce**
  - or to **improve** the **standards** themselves.

Manufacturing

- Therefore, where **performance** of the **manufacturing process** is measured against **standard** costs,
- it is **advisable** to make a **separate** evaluation of such activities as
  - **quality** control,
  - **production** scheduling, and
  - **make-or-buy** decisions

Manufacturing as a profit center

- **One** way to **measure** the activity of a **manufacturing** organization in its **entirety**
- is to **turn** it **int**o a **profit center** and give it **credit** for the **selling price** of the products **minus estimated marketing** expenses.
- Such an **arrangement** is far from **perfect**,
  - partly because many of the factors that influence the volume
  - and mix of sales are beyond the manufacturing manager's control.
- However, it **seems** to **work better** in some **cases**
  - than the **alternative** of **holding** the manufacturing operation **responsible only** for **costs**

Manufacturing

- Some authors maintain that **manufacturing** units should **not be** made **into** profit **centers**
  - unless they sell a large portion of their output to outside customers;
- they regard units that sell primarily to other business units as ***pseudo*** **profit centers**
  - on the grounds that the **revenues** assigned to **them** for **sales** to other **units** within the **company** are **artificial**.
- Some **companies**, nevertheless, do **create** profit **centers** for such units.
  - They **believe** that,
  - if **properly designed**, the system can **create** almost the same **incentives** as those provided by sales to outside **customers.**

Service and Support Units

- Units for **maintenance**, **information** technology, **transportation**, **engineering**,
- **Consulting**, **customer service**, and similar support activities
  - can all be made into **profit centers**.
- These may operate out of **headquarters** and **service**
  - **corporate divisions**,
  - or **they** may **fulfill** similar functions within **business** units.
- They **charge** customers for **services rendered**,
  - with the financial **objective** of generating enough **business** so that their **revenues** equal their **expenses**.

examples

Administrative Service Category	Percent of Firms That Charge*	Method of Determining Charge (by percent) Usage (actual or estimated)	Prorated	Other
1. Finance and accounting	73%	35%	54%	11%
2. Legal	70	35	55	10
3. Electronic data processing	87	63	29	8
4. General marketing services	73	35	56	9
5. Advertising	72	50	41	9
6. Market research services	70	36	54	10
7. Public relations	63	24	62	14
8. Industrial relations	70	32	56	12
9. Personnel	70	35	53	12
10. Real estate	62	37	53	10
11. Operations research department	60	47	42	11
12. Purchasing department	51	40	51	9
13. Top corporate management overhead	63	13	72	15
14. Corporate planning department	61	20	66	14

Service and Support Units

- When service units are **organized** as **profit centers**,
  - their managers are **motivated** to **control costs**
    - in order to **prevent** customers from going elsewhere
- while **managers** of the **receiving units**
  - are **motivated** to make **decisions** about
    - **whether** using the **service** is **worth** the price

Other Organizations

- A company with branch **operations** that are **responsible** for **marketing** the company's products
  - in a particular geographical area
- is often a **natural** for a **profit center**.
- Even though the **branch managers** have **no** manufacturing or **procurement responsibilities**,
  - **profitability** is often the best **single measure** of their performance.
- Furthermore, the profit **measurement** is an excellent **motivating** device.

Examples:

- the individual **stores** of most retail **chains**,
- the individual **restaurants** in **fast-food** chains, and the
- i**ndividual hotels** in hotel chains are **profit centers**.

Measuring Profitability

Measuring Profitability

- There are **two types** of profitability **measurements** used in **evaluating** a **profit** center,
  - just as there are in evaluating an organization as a whole.
- First, there is the measure of ***management performance***,
  - which **focuses** on how well the **manager** is **doing**.
  - This measure is used for **planning**, **coordinating**, and
  - **Controlling** the profit **center's** day-to-day activities and
  - as a device for **providing** the proper motivation for its manager

Measuring Profitability

- Second, there is the **measure** of ***economic performance,***
  - which focuses on how well the profit center is doing as an **economic entity**.
- The messages conveyed by these two measures may be quite different from each other.
- For example,
- the management **performance** report for a **branch store**
  - May **show** that the store's **manager** is doing an **excellent** job **under** the **circumstances**,
  - while the **economic performance** report may **indicate** that because of economic and **competitive conditions**
    - in its **area** the store is a **losing proposition** and should be **closed**

Measuring Profitability

- The **necessary** information for both **purposes** usually
  - cannot be **obtained** from a **single** set of data.
- **Because** the **management** report is used **frequently**,
  - while the **economic report** is prepared only on those occasions when economic decisions must be **made**,
- **considerations** relating to **management performance**
- **measurement**
  - have first **priority** in systems design
    - that is, the system should be designed to measure management performance routinely,
- with **economic information** being **derived** from these **performance** reports
  - as well as from other sources

Types of Profitability Measures

- A **profit center's** economic **performance**
- is always **measured** by net **income**
  - (i.e., the income **remaining** after all **costs**,
    - including a fair share of the **corporate overhead**,
  - have been **allocated** to the **profit center**).

Profitability Measures

The **performance** of the profit center manager may be evaluated by five different measures of **profitability**:

- (1) **contribution** margin,
- (2) **direct** profit,
- (3) **controllable** profit,
- (4) **income before income taxes**, or
- (5) **net income**.

Profit center income statement

		Profitability Measure
Revenue	$1,000	
Cost of sales	600	
Variable expenses	180	
Contribution margin	**220**	**(1)**
Fixed expenses incurred in the profit center	90	
Direct profit	**130**	**(2)**
Controllable corporate charges	10	
Controllable profit	**120**	**(3)**
Other corporate allocations	20	
Income before taxes	**100**	**(4)**
Taxes	40	
Net income	**$ 60**	**(5)**

Percentages of Companies Using Different Methods of Measuring Profit

Types of Expenses Charged to the Profit Center	United States[a]	Holland[b]	India[c]
Depreciation charge	98%	96%	98%
Fixed expense incurred in the profit center	99	N/A	N/A
Corporate general and administrative expenses allocated to the profit center	64	44	N/A
Income tax expense	40	22	10

(1) Contribution Margin

- **Contribution** margin reflects the **spread**
  - between **revenue** and **variable expenses**.
- The principal **argument** in favour of using it
  - to **measure** the performance of profit center managers is that
    - since **fixed expenses** are **beyond** their **control**,
  - **managers** should **focus** their attention on **maximizing contribution**

(1) Contribution Margin

- The **problem** with this argument is that its premises are **inaccurate**;
  - in fact, almost all fixed **expenses** are at **least partially controllable** by the manager, and
  - some **are** entirely controllable
- **Presumably**,
  - s**enior** management wants the profit center to keep these **diseretionary expenses**
    - in line with **amounts** agreed on in the budget **formulation process**.
- A **focus** on the contribution margin **tends** to direct **attention** away from this **responsibility**.
- **even** if an **expense**,
  - such as **administrative** salaries
- **cannot** be **changed** in the **short run**, the **profit center manager** is still **responsible** for controlling employees' **efficiency** and **productivity**

(2) Direct Profit

- This **measure** reflects a profit center's **contribution** to the **general overhead** and profit of the **Corporation.**
  - it **incorporates all expenses**
  - either **incurred** by or **directly traceable** to the profit center,
    - **regardless** of whether or not these items are **within** the profit **center** manager's **control**.
- **Expenses** incurred at **headquarters**, are **not included** in this **calculation**.
- A **weakness** of the direct profit measure is that
  - it does **not recognize** the **motivational benefit** of charging **headquarters costs**

(3) Controllable Profit

- Headquarters expenses can be **divided** into two categories:
  - **controllable** and **noncontrollable**
- The former category includes **expenses** that are **controllable**,
- at least to a **degree**,
  - by the **business** unit manager **information technology** services,
  - If these costs are **included** in the **measurement** system,
  - **profit** will be what **remains** after the **deduction** of **all expenses**
  - that **may** be ***influenced*** by the **profit center manager**.
- A major **disadvantage** of this measure is that
  - because it **excludes noncontrollable headquarters expenses**
  - it **cannot** be directly **compared**
    - with either **published data** or trade association data reporting
    - the **profits** of other **companies** in the **industry**.

(4) Income before Taxes

- In this measure, **all corporate overhead** is **allocated** to **profit centers**
  - based on the **relative amount** of expense each profit center incurs.
- There are two **arguments** against such **allocations**.
- First, **since** the costs incurred by **corporate** staff departments
  - such as **finance**, **accounting**, and **human resource** management are **not controllable** by **profit center managers**,
  - these **managers should not** be held **accountable** for them.
- Second, it may be **difficult** to **allocate** corporate staff
- services in a **manner** that would **properly** reflect the amount of costs incurred by each profit center.

(4) Income before Taxes

- There are, however, **three arguments in favor** of **incorporating** a portion of corporate **overhead** into the profit **centers**’ performance **reports**.
- First, **corporate** service units have a **tendency** to **increase** their **power** base and to **enhance** their own **excellence**
  - **without regard** to their **effect** on the **company** as a whole.
- **Allocating** corporate overhead costs to **profit centers**
  - **increases** the **likelihood** that profit **center** managers will **question** these **costs**,
  - thus serving to keep head office spending in check.

(4) Income before Taxes

- Second, the **performance** of each profit **center** will **become**
  - more **realistic** and more **readily comparable** to the **performance** of **competitors** who pay for similar services.
- Finally, when **managers** know that their **respective centers will not show** a profit **unless** all **costs**,
  - **including** the allocated **share** of **corporate overhead**, are **recovered**,
  - they are **motivated** to make **optimum long-term marketing decisions** as to pricing,
  - **product** mix, and so forth, that will **ultimately** benefit
  - (and even ensure the viability of) the company as a whole

(4) Income before Taxes

- If **profit centers** are to be **charged** for a portion of corporate **overhead**,
  - this item **should** be **calculated** on the basis of **budgeted**, **rather** than **actual** costs,
- This **ensures** that
  - profit **center managers** will not **complain** about **either** the **arbitrariness** of the **allocation** or
  - their **lack** of control **over** these **costs**,
- since their performance reports will show no variance in the overhead allocation

(5) Net Income

- Here, **companies** measure the **performance** of **domestic** profit centers
  - **according** to the **bottom line**, the amount of net income after income tax.
- There are two **principal arguments** against using this **measure**:
- (1) **aftertax income** is often a **constant percentage** of the pretax income,
  - in which case there would be **no advantage** in incorporating income taxes, and
- (2) **since** many of the **decisions** that **affect income** taxes are **made** at **headquarters**,
  - it is **not appropriate** to **judge profit center managers** on the **consequences** of **these decisions**

(5) Net Income

- There are **situations**, however, in **which** the effective **income** tax **rate does vary among** profit **centers**.
- For **example**, foreign subsidiaries or business units
  - with **foreign operations** may have **different effective** income **tax rates**.
- In other cases, **profit centers** may **influence**
  - **Income taxes** through their **installment credit policies**,
  - their **decisions** on **acquiring** or **disposing** of **equipment**, and
  - their use of other **generally** accepted **accounting procedures** to **distinguish** gross income from **taxable** income.
- In **these situations**, it may be **desirable**
  - to **allocate** income **tax expenses** to **profit centers** not only
  - to **measure** their **economic profitability**
  - but also to **motivate managers** to **minimize tax** liability

Revenues

- **Choosing** the appropriate revenue **recognition method** is **important**.
- Should **revenues** be **recorded** when an order is made, when an order is shipped, or when **cash** is **received**?
- In addition to that **decision**,
  - there are other **issues** relating to **common revenues** that may require **consideration.**
- In some situations **two** or **more profit centers** may **participate** in a **successful sales effort**;
- ideally, each **center** should be given **appropriate credit** for its **part** in the **transaction**

Revenues-example

- a **salesperson** from Business **Unit A** may be the main **company contact** with a certain **customer**,
  - but the orders the customer places with that **salesperson** may be for **products** carried by **Business Unit B.**
- The Unit A **salesperson** would not be likely
  - to **pursue** such orders if all resulting **revenues** were **credited** to Unit B

Revenues-example

- Many **companies** do not devote a great deal of **attention** to solving these **common** revenue **problems**.
  - They take the position that the identification of precise **responsibility** for **revenue generation** is too **complicated** to be **practical**,
  - And that sales personnel must recognize they are working not only for their own profit center but also for the overall good of the company.
- **Other** companies **attempt** to **untangle** the **responsibility** for common sales by **crediting** the business **unit**
  - that **takes** an **order** for a product **handled** by **another unit** with the **equivalent** of a **brokerage commission** or a finder's fee