Profit Centers

By Kornél Tóth
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 that clearly 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 general 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;
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.
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 areas**
  - 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 into 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**
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.**
<table>
<thead>
<tr>
<th>Administrative Service Category</th>
<th>Percent of Firms That Charge*</th>
<th>Usage (actual or estimated)</th>
<th>Prorated</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Finance and accounting</td>
<td>73%</td>
<td>35%</td>
<td>54%</td>
<td>11%</td>
</tr>
<tr>
<td>2. Legal</td>
<td>70</td>
<td>35</td>
<td>55</td>
<td>10</td>
</tr>
<tr>
<td>3. Electronic data processing</td>
<td>87</td>
<td>63</td>
<td>29</td>
<td>8</td>
</tr>
<tr>
<td>4. General marketing services</td>
<td>73</td>
<td>35</td>
<td>56</td>
<td>9</td>
</tr>
<tr>
<td>5. Advertising</td>
<td>72</td>
<td>50</td>
<td>41</td>
<td>9</td>
</tr>
<tr>
<td>6. Market research services</td>
<td>70</td>
<td>36</td>
<td>54</td>
<td>10</td>
</tr>
<tr>
<td>7. Public relations</td>
<td>63</td>
<td>24</td>
<td>62</td>
<td>14</td>
</tr>
<tr>
<td>8. Industrial relations</td>
<td>70</td>
<td>32</td>
<td>56</td>
<td>12</td>
</tr>
<tr>
<td>9. Personnel</td>
<td>70</td>
<td>35</td>
<td>53</td>
<td>12</td>
</tr>
<tr>
<td>10. Real estate</td>
<td>62</td>
<td>37</td>
<td>53</td>
<td>10</td>
</tr>
<tr>
<td>11. Operations research depart.</td>
<td>60</td>
<td>47</td>
<td>42</td>
<td>11</td>
</tr>
<tr>
<td>12. Purchasing department</td>
<td>51</td>
<td>40</td>
<td>51</td>
<td>9</td>
</tr>
<tr>
<td>13. Top corporate management overhead</td>
<td>63</td>
<td>13</td>
<td>72</td>
<td>15</td>
</tr>
<tr>
<td>14. Corporate planning department</td>
<td>61</td>
<td>20</td>
<td>66</td>
<td>14</td>
</tr>
</tbody>
</table>
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
  – individual 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

<table>
<thead>
<tr>
<th></th>
<th>Profitability Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$1,000</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>600</td>
</tr>
<tr>
<td>Variable expenses</td>
<td>180</td>
</tr>
<tr>
<td><strong>Contribution margin</strong></td>
<td><strong>220</strong></td>
</tr>
<tr>
<td>Fixed expenses incurred in the profit center</td>
<td>90</td>
</tr>
<tr>
<td><strong>Direct profit</strong></td>
<td><strong>130</strong></td>
</tr>
<tr>
<td>Controllable corporate charges</td>
<td>10</td>
</tr>
<tr>
<td><strong>Controllable profit</strong></td>
<td><strong>120</strong></td>
</tr>
<tr>
<td>Other corporate allocations</td>
<td>20</td>
</tr>
<tr>
<td><strong>Income before taxes</strong></td>
<td><strong>100</strong></td>
</tr>
<tr>
<td>Taxes</td>
<td>40</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td><strong>$ 60</strong></td>
</tr>
</tbody>
</table>
Percentages of Companies Using Different Methods of Measuring Profit

<table>
<thead>
<tr>
<th>Types of Expenses Charged to the Profit Center</th>
<th>United States&lt;sup&gt;a&lt;/sup&gt;</th>
<th>Holland&lt;sup&gt;b&lt;/sup&gt;</th>
<th>India&lt;sup&gt;c&lt;/sup&gt;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Depreciation charge</td>
<td>98%</td>
<td>96%</td>
<td>98%</td>
</tr>
<tr>
<td>Fixed expense incurred in the profit center</td>
<td>99</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Corporate general and administrative expenses allocated to the profit center</td>
<td>64</td>
<td>44</td>
<td>N/A</td>
</tr>
<tr>
<td>Income tax expense</td>
<td>40</td>
<td>22</td>
<td>10</td>
</tr>
</tbody>
</table>
(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,
  – senior management wants the profit center to keep these discretionary 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.
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.
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
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