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The Demise of Cost and Profit Centers

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Abstract

The Balanced Scorecard offers a previously unrecognized benefit: a new way of looking at the traditional organizational structure of cost and profit centers. Every unit, by contributing to effective strategy execution, has the opportunity to support and create profit. This capability has important implications for specifying objectives and evaluating the performance of all organizational units.

In the mid-1960s, three Harvard Business School faculty members, Robert Anthony, John Dearden, and Richard Vancil, authored a classic contribution to management control, *Management Control Systems* (MCS).[1] The MCS book, among many insights, contained an important taxonomy to describe the structure and systems used by different decentralized organization units. The taxonomy explored the relationship between the design of decentralized organizations and the motivations of and incentives for those who manage them. MCS identified five different types of decentralized organizational units.

1. The Profit Center. Many operating unit managers have responsibility and authority for both production and sales. They make decisions about what products and services to produce, how to produce them, their quality level, price, sales and distribution systems. But these managers may not have the authority to determine the level of capital investment in their facilities. In these cases, operating profit may be the single best (short-term) performance measure for how well the managers are creating value from the resources the company has put at their disposal. Such a unit, in which the manager has almost complete operational decision-making responsibility and is evaluated by a straightforward profit measure, is called a **profit center.**

2. The Investment Center. When a local manager has all the responsibilities described above as well as the responsibility and authority for his or her center's working capital and physical assets, the manager is running an investment center. The performance of such a unit is best measured with a metric that relates profits earned to the level of physical and financial assets employed in the center. Investment center managers are evaluated with metrics as return on investment (ROI) and economic value-added.

3. The Standard Cost Center. A standard cost center is a production or operating unit in which someone other than the local manager determines the outputs that will be produced as well as the expected inputs required to produce each unit of output. Industrial engineers and cost accountants specify the quantity and price standards for the materials, labor, energy, and machine time required to produce each widget, the generic term for a manufactured good, . The cost center manager's job is to produce the

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[1] Authors, *Management Control Systems*, Richard D. Irwin publishing, 1965. The book, with new authors, is now in its 12th edition.

demanded quantity and mix of widgets in an efficient manner, as determined by the standard cost system. Standard cost centers are also found in service industries, such as the fast-food business, banking, and health care, where cost accountants establish standard costs for producing hamburgers and milk shakes, processing checks and deposits, or performing laboratory and radiological tests. The performance of a cost center manager is evaluated by a complex system of cost variances that compare actual to budgeted cost performance.

4. The Revenue Center. A revenue center, typically a market or sales unit, has responsibility for selling the finished goods produced by a manufacturing division (a cost center) or the products offered by a service organization. Because a revenue center typically has discretion in setting the selling price (or in negotiating discounts off the list price), it is held accountable for generating targeted levels of gross revenues. It often compensates its sales force with commissions based on the gross revenues they generate.

5. The Discretionary Expense Center. Staff units, including general and administrative (G&A) departments, such as finance, human resources, and legal; research and development (R&D) departments; and marketing units such as those performing advertising and promotion, are usually treated as discretionary expense centers. The output from these units is not easily measured in financial terms, and the relationship between the resources they expend (inputs) and the outcomes they produce is weak. Companies control these discretionary expense centers by negotiating and eventually authorizing an annual budget and then monitoring whether their actual spending remains within the budgeted amounts.

The MCS taxonomy reveals that decentralization can take many forms. Repetitive processes producing well-specified and easily measured outputs can be managed as *standard cost centers*, where the managers must meet externally generated demands for products according to a cost-minimizing, efficient standard. Marketing departments can be organized as *revenue centers*, with the objective of meeting targeted goals in sales revenue, market share, or contribution margin. Some functions for which the output is not easily measurable or where the outputs are not causally and deterministically related to the inputs expended cannot be controlled by the use of traditional techniques such as standard costs or budgets. These functions are usually organized as *discretionary expense centers* in which the level of expenditure and the number of personnel are determined by negotiation with central management to determine appropriate levels of quality and service. Much greater decentralization can occur when an operating unit is given responsibility both for acquiring inputs and selling or distributing its outputs. Such units can be organized as profit or investment centers. For all five types of organizational units, however, only financial metrics—cost, revenue, gross margin, profits, or ROI—were used for motivation, alignment, and rewards.

The Balanced Scorecard Revolution

When Dave Norton and I introduced the Balanced Scorecard in the 1990s, we described the limitations of financial metrics, such as profits and ROI, for motivating and

evaluating the performance of profit and investment centers. We claimed that financial metrics were no longer sufficient for measuring the annual performance of the managers of these units in creating long-term value. We advocated that the performance of such managers must include a variety of nonfinancial metrics designed to capture how well the unit's intangible assets built and expanded relationships with targeted customers; improved the quality and responsiveness of operating processes; created and introduced new products and services; enhanced the motivation and capabilities of employees; leveraged investments in data bases and information technology; and aligned the culture and climate linked to the unit's vision, mission, and strategy.

The BSC soon proved to be a more general and powerful performance management framework for units previously treated as profit and investment centers. Less well appreciated, however, is how the BSC has actually *eliminated* the need to treat the remaining decentralized units as standard cost centers, revenue centers, or discretionary expense centers. Let's treat each in turn.

Transforming the Cost Center

Empire Glass[2] was one of the most provocative cases in the MCS text and case book. The Empire Glass company treated a manufacturing plant, which had no authority for pricing, marketing, or sales activities, as a profit center, not a cost center. Class discussions always started with students actively criticizing this choice. Treating this manufacturing unit as a profit center violated all the rules they had just learned about what constituted a profit center. The Empire Glass plant merely produced products to customer orders. During the course of class discussion, however, students came to realize that the manufacturing plant actually had a substantial influence on sales and margins. Producing the right volume of product at high-quality levels, and delivering the order on time, contributed to satisfied, loyal customers. By holding the manufacturing manager of the plant accountable for a profit measure, he was motivated to learn how his plant could contribute to current and future sales, and sustain higher prices for the outputs the plant produced. If he were evaluated only by how much he beat the standard cost budget for the actual volume and mix of products demanded, the plant manager would have emphasized long production runs, ignored sales requests for expedited production and delivery, and failed to recognize the consequences of late deliveries, an incorrect product mix, or producing products that did not conform to specified quality standards.[3]

We now understand that forcing a plant such as the Empire Glass plant to be a profit, rather than a cost, center was a sub-optimal solution, caused by having to select only a single financial measure to evaluate the plant's performance. Today, with more than a decade of BSC experience, we can ask students to construct a strategy map and Balanced Scorecard for the Empire Glass plant. The primary financial metrics would include a

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[2] D. Hawkins, Empire Glass Company (A), HBS Case # 9-109-043.

[3] Robert Simons has formalized the role for holding managers responsible for a measure broader than their span of control in R. Simons, “"Designing High-Performance Jobs." *Harvard Business Review* (July/August 2005) and *Levers of Organization Design: How Managers Use Accountability Systems for Greater Performance and Commitment* (Boston: Harvard Business School Press, 2005).

comparison of actual to standard costs for the volume and mix of products produced. But the financial perspective would also include metrics for sales revenue and margins. These alert the manager to how his plant's quality, lead-time, and on-time delivery performance influence revenues and profits. And beyond this richer set of metrics in the financial perspective, students can draw upon three other nonfinancial perspectives—customer, process and learning and growth—to select leading indicators of the plant's performance.

In the customer perspective, we would include the metrics that capture the performance desired by Empire's most important customers; for example, short lead times, on-time delivery, and zero defect rates. For the process perspective, we would not only include metrics for manufacturing cost improvements, but also metrics for process cycle times, defect rates, and yields. We could also introduce metrics of flexibility and ease of introducing new product varieties into large-scale manufacturing. For the learning and growth perspective, we would measure the percentage of employees trained in Six Sigma and employees' awareness of how the plant's production and delivery performance influences customer satisfaction. What a revolution in thinking and in practice! The plant is neither a cost nor a profit center; it is a strategic operating unit whose alignment with company strategy can now be comprehensively but succinctly visualized, measured, motivated, and evaluated.

Revisiting the Revenue Center

Let's next consider revenue centers, which have historically been measured by the dollar volume and mix of products sold. In building a Balanced Scorecard for a revenue center, we specify, in the customer perspective, objectives for market and account share, and for customer satisfaction, loyalty, and growth in targeted customer segments, accounts, and channels. These customer metrics provide more specificity and guidance for marketing and sales units. The process perspective focuses on customer management processes: acquisition, retention, and growth. And the learning and growth perspective identifies the skills and knowledge required for promoting, branding, and selling the company's products and services; emphasizes the development of customer databases and the capabilities for customer data-mining analytics; and signals the importance of a customer-focused culture.

Just as manufacturing and operations units like Empire Glass can now, through the BSC, internalize their impact on revenues, sales and marketing units should think about their impact on costs. These units, with their metrics on customer outcomes, customer processes, and customer learning and growth metrics, may become too customer-focused. They may attempt to generate customer orders and loyalty by offering excessive product and service customization, highly responsive delivery options, and expanded post-sale customer services. All these offerings are welcomed by customers and lead to more satisfaction and increased business. But the customization, responsive delivery, and expanded post-sales services also raises costs throughout the company. Engineering must design the new product variants and the processes to produce them; manufacturing and operations incur high costs to produce the customized products in short production runs; distribution incurs costs for frequent, expedited deliveries on short lead times; and the field-service and home-office support units must devote considerable resources for the promised

levels of customer service. The marketing and sales decisions thus have profound consequences for costs incurred elsewhere in the company. As with Empire Glass, the choice of financial measures for evaluating the performance of the marketing and sales units is no longer an "either-or" choice between revenues and profits. These units can measure both. The Balanced Scorecards for the marketing and sales units could include metrics on profitability, the cost-to-serve for key customers, the frequency and magnitude of losses in unprofitable customer relationships, and changes in operating costs associated with providing special features or services. Activity-based costing (ABC) makes it feasible to calculate the costing of every customer order and the profit or loss of every customer relationship.[4] Companies can now expand the performance measurement of their marketing and sales' units to include profits, not just sales.

The New Discretionary Expense Center

Perhaps the greatest breakthrough in measuring, motivating, and evaluating the performance of decentralized units occurs in discretionary expense centers — corporate overhead departments—which have historically been controlled only by comparing their actual spending to somewhat arbitrarily determined budgets. Activity-based costing and the Balanced Scorecard enable discretionary expense units to be evaluated by the same tools as those used for profit, revenue, and cost centers. First, ABC helps them drive their expenses down to the specific services they provide. For example, consider the accounts receivable (A/R) department within finance. By analyzing the time demands on the employees in A/R, we can assign A/R's costs simply and accurately to the operating units that create the work, using such cost drivers as number of invoices issued, number of cash collections processed, number of customer credit checks performed, and number of customer files maintained. Furthermore, time-driven ABC systems can measure the unit costs of the repetitive processes done within HR (training, employee benefit counseling, and performance management appraisals) and IT (providing CPU capacity, storage capacity, and connect time). The ABC innovation enables the resource costs of corporate support departments to be charged out to operating units just as the outputs from manufacturing units are charged out, via standard costs, to marketing and sales units. In effect, ABC enables discretionary expense centers to become cost centers with a financial goal to break even—to recover their expenses through cost-recovery pricing schemes based on the actual demands made by operating units on the support units' resources.

But organizations needn't stop there. An entire chapter of the recent Kaplan-Norton book, *Alignment*, explains how strategy maps and scorecards can be developed for such units as finance, IT, and human resources, among many others.[5] **Figure 1** provides a template that can be applied to create a strategy map for any corporate staff or support unit. This innovation enables every corporate support unit to be treated not as a discretionary expense center—not even as a break-even cost center— but as a strategic

[4] R. S. Kaplan and S. R. Anderson, "Time-Driven Activity-Based Costing," *Harvard Business Review* (November 2004): 131-138.
[5] "Aligning Support Functions," Chapter 5 in R. S. Kaplan and D. P. Norton, *Alignment* (Boston: HBS Press, 2006): 119-167.

business unit in its own right. How can an organization accomplish this dramatic transformation?

Starting with the financial perspective (see Figure 1), we can continue to demand that support units stay within their budget. The units can also have an objective to lower the cost of supplying services to their customers—the operating and support units. We can also require them to break even by ensuring they recover their expenses by pricing their services on a cost basis. Beyond the cost focus, many support units add corporate- and business-unit revenue and profit objectives to their scorecards to reflect the role they play in contributing to operating units' financial objectives. While support units neither produce products nor service external customers, they can strive to help make the operating units they serve more productive and more profitable with these customers.

Just as operating units must work closely with the firm's external customers, support units must understand their (internal) customers' strategies and align their service offerings to contribute to their customers' success. These objectives typically appear in the support unit's BSC customer perspective. Many support unit scorecards therefore include an objective to become "their customers' trusted adviser" and measure this objective with metrics from service-level agreements and from customer feedback. As with revenue and profit in the financial perspective, some support units may even incorporate external customer metrics in their scorecards to recognize how they can directly create value for the operating units' customers. For example, an IT shared services unit can create new platforms and new capabilities for servicing customers that help strategically differentiate the company's operating units.

Several support units may have additional customers to consider in their strategy maps and scorecards. HR units treat employees as their customers, providing them with competency and leadership development training, career development advice, performance management systems linked to their units' strategy, and competitive compensation and benefit packages. Finance units treat the company's investors, analysts, regulators, and tax authorities as their customers. Finance offers them reporting and disclosures about the company's financial progress, risk management and internal control processes; and tax reporting that demonstrates that the company minimizes tax payments while remaining within the laws and regulations of the countries in which it operates.

All support units can identify the critical processes they perform to deliver services to internal and external customers, processes highlighted in the Balanced Scorecard's process perspective. Though often routine and transactional, these processes are nonetheless vital, such as operating the general ledger and accounts receivable function (finance), the compensation and benefit system (HR), and the computing and networking infrastructure (IT). Support departments should constantly strive to lower the cost and raise the reliability and quality of their basic support services. But they should not stop there. Support departments should expand their scope to identify the processes that enable them to be trusted advisers to operating unit leaders and help them achieve their differentiating strategies. If a support unit does not offer some differentiating

services to its internal customers, it runs a high risk of the company eliminating the unit and outsourcing the function to a lower cost external provider.

Finally, the support units’ customer-focused strategies require upgrading the skills and capabilities of their employees so they are equipped to be trusted advisers to business unit heads and relationship managers in the units they support. This generally requires significantly enhanced information technology capabilities, and almost always a shift in mindset and culture from being a central and captive provider of functional expertise to being a customer-focused shared service unit.

Summary

The development of strategy maps and Balanced Scorecards has transformed the foundation of management control systems. The leading paradigm of organizational structure and control of just a generation ago, based upon cost, profit, investment, revenue and discretionary expense centers, has been replaced by a robust, powerful framework in which *every* organizational unit—whether line or staff, whether centralized or decentralized—can be considered a strategic business unit. The management control system is no longer based on the budget – whether for profits, ROI, costs, revenues, or discretionary expenses. Companies now use the more general and powerful strategy management system, built upon the framework of strategy maps and Balanced Scorecards, to motivate, align, and evaluate the performance of diverse organizational units.

Figure 1 Support Unit Strategy Map