

## CORPORATE GOVERNANCE

# Measuring Profit Center Managers

by John Dearden

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**M**any large companies still measure the financial performance of their profit center managers with techniques developed in the 1920s. They are based on return on investment. In this age of fast-paced change in both technology and management information systems, the attachment to these systems is not only strange but debilitating. Over the past 20 years, I've discussed the problem with senior and division managers both here and abroad and found that, while they recognize the difficulties such systemic rigidities impose, they do not know how to change their systems.

Before management can build a new system, it must understand what is wrong with the old one. I have discovered that the use of return on investment is symptomatic of other, basic conceptual errors in profit center measurement systems. These errors are:

1. The failure to distinguish between techniques used to measure past financial performance and those required to establish future performance objectives.

2. The failure to differentiate between systems that measure the performance of the profit center and those that measure the performance of its managers.
3. The failure to segment variances from the budget by differences in the way that managers can influence them.

In this article I will describe the basis for these conceptual errors, explain how they result in suboptimal measurement systems, and suggest action management can take to correct the problems the systems create.

## **Conceptual Flaws**

In using traditional accounting systems to measure organizational units' performance, companies judge the adequacy of profits by comparing the amounts earned during a series of time periods and calculating the rates of return on the investments made.

Most companies emulate the systems that Du Pont and General Motors developed in the 1920s. Both businesses decentralized profit responsibility to operating units and at the same time began to use ROI to measure their units' financial performance. They expressed future profit objectives in terms of return on divisional assets and began to base projected performance on past results. Later they formalized these ROI objectives into profit budgets.

### **Measuring vs. projecting**

Return on investment is a valid technique for measuring past profitability. In fact, it is the only technique that allows a company to compare profitability among organizations or investments. But it is not a valid way to set future objectives, because the historical costs of assets—on which it is based—are meaningless in planning future action. Regardless of how much a company pays for a group of assets or what amount of differential cash flow it projects in investment proposals, the only logical thing its managers can do—once the assets

are in place—is to use the assets to maximize future cash flow and to invest in new assets when the return from these assets is expected to equal or exceed the company’s cost of capital. The failure to make this distinction—between measuring the past and projecting the future—is the principal reason that companies continue to use ROI to measure the financial performance of their managers.

Not making this distinction adds to the undesirable side effects already inherent in ROI as managers try to maximize their return on investment. (For a summary of these side effects, please see the sidebar “How ROI Can Hurt.”)

#### How ROI Can Hurt

I have found that using return on investment to measure profit center managers causes corporate problems because:

- The emphasis is on optimizing a ratio, which could discourage growth in the most profitable divisions. Investments in high profit divisions may lower their return, while the same investment in low profit divisions could improve it.
- Investments that might earn satisfactory returns will not do so at first because ROI requires that the investments be increased by the total gross book value of the new assets. Managers may not invest if

Not only are historical accounting values of existing fixed assets not relevant, but as soon as a new asset is added, neither the cost nor the projected savings are relevant to future planning except to ascertain how well estimates have been made.

Companies should express profit objectives for both the profit center and its manager in terms of absolute dollars of profit, which are based on the projected potential of existing resources to generate cash flow.

#### **The manager vs. the profit center**

Current systems also fail to distinguish explicitly between the measurement of the financial performance of a manager and that

they expect their tenure to be short. Also, their returns will increase over time if they don't make new investments.

- All assets in the same division, whether special-purpose assets, general-purpose assets, or working capital, must earn the same rate of return. Moreover, this rate of return is often inconsistent with the company's cost of capital.
- The same assets in different divisions may have different implicit interest rates, which may lead to different inventory decision rules in different divisions for identical items of inventory.
- Under certain conditions, division managers can increase their rate of return by scrapping perfectly good assets.

of the organizational unit being managed. It is important to make this distinction because:

- A company can measure a profit center's financial performance only in absolute terms, while it can measure the unit's head only in relative terms. Managers' performance is limited by their own units' profit potential. Otherwise, managers of high-profit divisions would always be considered successful and managers of low-profit divisions, marginal or unsuccessful.
- The extent to which a manager can control an item of revenue or expense is irrelevant to measuring a profit center's performance. For example, the impact of foreign exchange translation gains or losses is important to evaluating a subsidiary's profitability. This impact is entirely irrelevant, however, to judging the performance of that subsidiary's manager.

Many multinationals measure foreign subsidiary managers on the basis of the American dollar, so when the dollar goes up,

the performance of the subsidiary goes down. Senior managers believe that tying the foreign subsidiary managers to the dollar forces them to make up for shortfalls in other areas, so

that the impact on the corporation as a whole is neutral. But the impact on the manager is very real and demotivating. Managers abroad rightly complain to headquarters that they have no influence on the very factors with which they are being judged.

From the company's point of view, this tie to the dollar may force managers to make up for the problems themselves, but it also gives managers a screen behind which to hide mistakes. When the dollar goes down, the subsidiary's performance goes up, no matter what. Poorly run divisions have been able to hide their failures for years when the dollar has been weak.

- The methods used to measure managers affect the way they act. If companies measure ROI, their managers will do all they can to optimize the ratio, and that may result in suboptimal decisions.

Of course few, if any, companies do measure managers in absolute terms. Almost all companies measure managers against profit budgets, which should take into account the potential profitability of the resources being managed. But by using a single system to measure both the organizational unit and its manager, the company includes items that are irrelevant to management performance and may also exclude items that are relevant. The performance criteria for the profit center (return on investment, for example) differ from those for the manager (actual profit compared with budgeted profit, for instance).

I believe that companies should separate their measurement systems and use the traditional accounting system for profit center financial statements and separate profit budget reports to measure managers.

## **Segmenting variances from the budget**

Most companies begin the budgeting process by reviewing a strategic plan. The strategic planning process, of course, affects the profit budget. The financial aspects of the strategic plan must be in terms of future cash flow; historical costs are not important to the plan. And the plan is for the profit center, not its manager. Only when the company converts the plan's first year into a detailed profit budget does the manager's responsibility become clear.

In formulating a better profit budget, top management must decide for which items profit center managers are to be held responsible and the degree to which they must meet specific goals. Very few items are entirely controllable by managers, but very few items cannot be influenced by managers. It is important to remember that the distinction is *not* controllability but the ability to influence.

The company should not automatically consider favorable variances good and unfavorable ones bad. It can judge good or poor performance only after it analyzes variances against management explanation.

I propose as a guideline for drawing up the profit budget that the company include only items that managers can influence. Profit center managers are, then, responsible for doing their best to meet or exceed this goal and for explaining the reasons for any variances and what they are doing to correct unfavorable variances.

In general, I believe a profit center manager can influence and thus be held responsible for:

1. All profit and loss items generated directly by the profit center.
2. Any expense incurred outside the center at head-quarters or other units for which the center can be billed directly.

3. An expense equal to the controllable working capital (usually receivables and inventories less payables) multiplied by an interest rate (the company's marginal borrowing rate, for instance). I believe such a charge is necessary to take into account trade-offs between the levels of working capital and profits. For example, higher inventories can reduce losses from stock-outs, and liberalized credit terms can result in higher sales. Only the profit center manager knows and understands these trade-offs. Because conditions are constantly changing, it is usually not effective to budget working capital levels. The charge will motivate managers to make these trade-offs in the company's best interests. If managers can increase profits above the costs of carrying receivables and inventories, the company will benefit.

In the same spirit, the company would replace depreciation based on historical cost with an amount equal to depreciation based on replacement cost. Depreciation, like the book value of fixed assets, is generally irrelevant to budgeting because a company is primarily concerned with maximizing cash flow. Being a sunk cost, depreciation does not affect the measurement of a profit center's performance.

Depreciation is important in product profitability analysis, however, where management diagnoses areas that are doing well versus those that are doing poorly. Each product varies widely in its use of capital; to gauge profitability, it is necessary to include the replacement costs of the assets used in calculating depreciation.

Under my proposal, the budgeted amount and the actual amount in the budget report would be the same, so depreciation would not affect performance. In fact, managers could omit depreciation from their reports and still calculate their products' profitability. If included, this figure will get greater visibility and consequently will more likely be used.

I advocate a profit budget expressed in terms of dollars to be earned in the budget year. The amount should represent the best estimate of the profit center's potential cash flow as developed through the strategic planning process. The profit budget will include only the parts of the plan a manager can influence. It is the manager's personal financial goal. The manager must explain any deviations from it.

## Reporting Against Budget

I would divide the reporting system that accompanies the budgeting system into three parts: (1) an analysis of variances from budget, (2) an explanation of the causes of those variances and any corrective action being taken, and (3) a forecast for the year. Many senior executives have trouble getting realistic (or even honest) explanations and forecasts from profit center managers, especially when the variances are unfavorable. The worse the variance, the greater the danger of cover-up.

This serious problem can be solved if profit center managers know precisely what their financial objectives are and are tested against only the income and expense they can influence. By organizing the analysis to separate variances by the degree of management responsibility, the company will increase the reliability and accuracy of the budget reports.

In most profit budget reporting systems, companies do not classify variances explicitly by the degree of influence management has on them. The practice leads to considerable ambiguity in the explanation of variances and the evaluation of performance. The report should indicate the difference in the degree of influence that a profit center manager can exert on each variance. If a company treats all variances as if they were homogeneous, it may perceive a favorable variance on which the manager has little influence as an offset to an unfavorable variance on which the manager has considerable influence.

Instead, companies should classify variances according to whether they are forecast, performance, or discretionary cost variances.

### **Forecast Variances**

I have found some confusion over the difference between a budget and a forecast, which some managers tend to treat as the same thing. A budget is not a forecast. A budget is a management plan and is based on the assumption that steps will be taken to make events correspond to the plan. A forecast is a prediction of what will most likely happen and carries no implication that the forecaster will attempt to shape events to realize the forecast. A projection is not a prediction but an estimate of what will happen if various conditions and situations exist.

The typical profit budget includes many forecasts. A company should treat them separately because it should judge managers solely on their ability to manage—not on their ability to forecast.

Perhaps the most important forecast in a typical profit budget is that of the total level of sales activity expected in the industry during the budget period. Everybody knows that swings in industry volume can sometimes affect profits to such a degree that all other variances appear minor in comparison.

By isolating the industry volume variance, you can more easily evaluate its impact—see that the volume is going down, for example, but that the manager is increasing market penetration. The industry volume variance allows you to see that the manager is doing well despite adverse conditions.

Each budget also forecasts the level of purchase prices on such costs as raw materials, utilities, supplies, and wages and salaries. The profit center manager normally has little, if any, influence over them. It is also necessary to forecast the level of selling prices, another item over which the manager has limited control. If, however, the budget were to combine purchase and sales price variances, they should offset each other because changes in the purchase prices should affect selling prices. Profit center managers *can* influence the effect of price level cost changes on profitability.

### **Performance variances**

These variances include market share and operating costs. Because the manager can affect his or her unit's market share and its efficiency, they are the two most important variances a company can use to evaluate the profit center manager. Moreover, they are the most concrete, for they leave the manager little room for ambiguity in explaining them.

In manufacturing profit centers, the most important performance variables are materials usage, direct labor, and overhead. In a service industry like a clothing chain, the actual costs of operating the stores, less the budgeted costs, are important performance variables.

Performance variables measure the profit center's level of efficiency and effectiveness. The profit center manager agrees to go after a given market share and to operate at a certain level of efficiency.

### **Discretionary expense variances**

These expenses include administration, marketing, and research and development.

Variances in these expenses indicate only whether more or less money has been spent than originally budgeted. They do not indicate efficiency or inefficiency, as other variances do. A company must segregate discretionary expense variances from the others because managers should not offset unfavorable performance with favorable discretionary expense variances.

A company wants to avoid a situation in which a profit center manager takes budgeted objectives so seriously that he or she cuts back on marketing or product development costs to compensate for unfavorable manufacturing cost variances.

## The Bottom Line

In most decentralized companies, managers are under pressure to meet current goals. This pressure influences them to cover up bad news and to take short-term action that is not in the long-run interests of their companies. A system that holds managers responsible for what they really can influence and allows them to explain the reasons they cannot achieve certain goals will relieve some of this pressure. Managers feel freer to communicate bad news if their goals are clear and unambiguous and they know they will be measured on the variances from items for which they are clearly responsible.

The evaluation of subordinates is one of the most important responsibilities of senior management, if not *the* most important one. Evaluation usually involves the observation of a manager's performance over a period normally exceeding the year covered by the typical profit budget. The evaluation also involves measuring managers on several dimensions in addition to their financial performance. Even the best short-term financial measurement systems do not ensure fair evaluation. Without such systems, however, evaluations are much more likely to be unsatisfactory and profit center managers much more likely to take action contrary to the best interests of their companies.

It is difficult to change a financial measurement system that has been in place for a number of years. Generally, almost everyone involved—from the controller to the profit center manager—will resist change. The managers responsible are often reluctant to change because change implies that the current systems are defective. Profit center managers usually believe they can work within the present systems and are unsure of the new. But change is worth the effort necessary to achieve it.

It is quite easy to diagnose the potential problems many current measurement systems create and even easier to decide what corrective actions to take. The problem is not what to do but how to do it.

Companies cannot afford to continue to use the techniques developed in the 1920s to measure the performance of profit center managers in the 1980s. A system of evaluation that is less ambiguous will be more fair to everyone, but it is hard to start the process of change. Unless innovative senior managers begin, however, they will continue to demotivate performance instead of measure it.

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