Management Accounting – Performance Evaluation

The use of internal markets encourages responsibility centres to make decisions that benefit the organisation as a whole. That’s the idea, at least, writes Bob Scarlett.

Financial control systems represent a formal structure through which individuals in an organisation may be influenced to act in the interests of that organisation. They co-ordinate the decisions taken in different parts of the organisation, providing a way to assess how these decisions have been converted into results.

The prominence of financial control systems in modern organisations reflects the fact that accounting data is expressed in a numeric form that allows for easy collation and comparison with appropriate benchmarks. Decisions are commonly expressed, and performance is commonly measured, in financial terms.

Control is necessarily a hierarchical exercise, but it’s clearly not practical for a single person at the top to make all the decisions, so organisations are split into responsibility centres. The manager of a responsibility centre is set a certain objective and allowed some discretion in how it’s achieved. Determining the extent to which this objective has been achieved provides a performance measure for the centre. The system must be adapted to priorities and circumstances in each case. Accordingly, responsibility centres may be grouped under three main headings:

- Cost centres (CCs) – to which costs are attributed, but not revenues or capital.
- Profit centres (PCs) – to which costs and revenues are attributed, but not capital.
- Investment centres (ICs) – to which costs, revenues and capital are attributed.

A CC can be designed in two ways. Either it is given a fixed quantity of inputs and required to maximise outputs, or it is set a required level of outputs to achieve while minimising inputs. One example of the first type of CC is a public relations department, which is given a fixed budget to spend to achieve the best possible results. An example of the second type is a cleaning department, which is given certain areas to clean and told to minimise the costs of doing so. In both cases the CC manager has some autonomy in deciding how the operation is run. But the system guides the manager to act in a way that’s consistent with the interests of the organisation.

The CC’s one particular weakness is that it relies on the measurement of spending to assess performance. There is no direct incentive for the manager to enhance the quality of its output. Costs can always be contained by reducing quality. In the case of a CC, quality reduction is not identified by the use of financial performance metrics.

Many companies treat their IT departments as cost centres, often with unfortunate results. Simon Linsley, head of consultancy, IT and development at Philips, told Computer Weekly [May 30, 2006]: "The idea that IT is a cost centre and carries no profit or loss is dangerous and should be opposed wherever it is encountered.” He went on to describe how IT system installation projects were usually completed on time and within budget at Philips. But the hasty manner in which projects were implemented often caused serious disruption at operational level.

The manager of a CC has autonomy over either outputs or inputs, but not both. A PC manager has autonomy over both inputs and outputs. The objective of a PC is to maximise profit or achieve a profit target. The manager is allowed to make decisions concerning both the resources used and the outputs achieved.

In PCs, a reliance on financial performance measures does not create an incentive to reduce quality. Lowering quality would affect sales volumes and/or the selling price, which would affect
profit. The PC may also induce other behaviour that’s in the organisation’s interests. For example, unit costs in a CC may be minimised by use of long continuous production runs, but this manufacturing method is less suitable for a PC, because it results in high stock holdings and/or reduced responsiveness to individual customers’ needs, which would adversely affect profit.

An IT department may be organised as a PC. Typically, this involves invoicing other departments for its services and inviting competition from external consultants for installation projects. In this way, it should be encouraged not to force through system installations in an all-out bid to reduce costs.

But PCs still may not induce the most efficient use of capital employed in the operation. For example, a PC manager can increase profit by making sales on extended credit terms. But such credit sales engage capital in the form of debtors. This capital has a cost that is not attributed to the PC. So the PC may be encouraging a waste of resources.

In an IC, the manager has decision rights over costs, revenues and investments. One performance measure that relates to all three factors is return on investment. In its simplest form, ROI is calculated by dividing the trading profit achieved in a period by the capital engaged in the IC making that profit. This gives a percentage figure, which aids comparisons among ICs of different sizes and with financial interest rates.

The IC incentivises managers to make the most efficient possible use of the resources under their control. It offers them the widest possible autonomy while incorporating elements that induce them to act in the organisation’s interests.

ROI does have its problems. The value of capital employed used to calculate it is normally taken from the balance sheet. That makes its value vulnerable to the choice of accounting policies, meaning that it is never an unambiguous measure. Furthermore, it can discourage new investment – the immediate impact of acquiring new equipment is usually a decline in ROI.

The logic behind responsibility centres suggests that an organisation should be split into decoupled internal components with decision rights in each given to its own management team within certain parameters. Each component trades its services with the others at arm’s length, giving rise to an internal market. The UK public sector applied this concept widely in the nineties. Under its then director-general, Sir John Birt, the BBC introduced an internal market among its different units – technology, production, news etc. The development of an internal market has also been a feature of National Health Service reform.

So much for the theory. Practical experience has introduced us to a concept known as “failure of the internal market”. The BBC’s gramophone library, for example, was traditionally run as a CC. After Birt’s reforms were enacted this huge sound archive became a PC and was required to charge user departments in the BBC for borrowing its recordings. Soon programme researchers were buying their material more cheaply from high-street music retailers, having been told by their managers not to pay the library’s high usage fees. The truth was that the library was a vital resource that had to be treated as a CC. The BBC’s system soon became deeply unpopular and has largely been abandoned in recent years.

Responsibility centres and internal markets have much to offer. But insensitivity in their use or their application in inappropriate circumstances can do more harm than good. FM

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Baron Birt: introduced the internal market concept to the BBC in the nineties – with unanticipated consequences.