Chapter 5
Responsibility centres

Chapter learning objectives:

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Indicative syllabus content</th>
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| B.1 Discuss decision making in responsibility centres. | (a) Discuss the information needed for decision making in different organisational structures. | • Relevant cost information for cost centre managers: controllable and uncontrollable costs and budget flexing.
• Relevant revenue and cost information for profit and investment centre managers: cost variability, attributable costs, controllable costs and identification of appropriate measures of profit centre ‘contribution’.
• Alternative measures of performance for responsibility centres. |

| B.2 Discuss issues arising from the use of performance measures and budgets for control. | (c) Discuss the criticisms and behavioural aspects of budgeting in responsibility centres. | • Behavioural issues in budgeting: participation in budgeting and its possible beneficial consequences for ownership and motivation; participation in budgeting and its possible adverse consequences such as ‘budget padding’ and manipulation; setting budget targets for motivation; implications of setting standard costs etc.
• Criticisms of budgeting and the arguments for and against ‘beyond budgeting’. |
1. Decentralisation

**Decentralisation**: divisionalisation or decentralisation is an organisational structure common in large organisations where autonomous units are created. Each unit is given decision-making power and is accountable for its results.

**OBJECTIVES**

1. Ensure goal congruence
2. Increase motivation of management
3. Reduce head office bureaucracy
4. Provide better training for junior and middle management

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
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<tbody>
<tr>
<td>• Better decision-making by division managers as they are more aware of the local conditions, thus leading to more informed decisions.</td>
<td>• The top managers could lose control if there is a lack of communication and information available from the different divisions.</td>
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<tr>
<td>• Faster decision-making because fewer people are involved in the decision-making process. The top management will not usually be involved.</td>
<td>• In a divisional structure, the costs that are shared by the divisions are likely to be greater than in a centralised structure.</td>
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<tr>
<td>• This leaves the top management free to focus on strategic-level planning.</td>
<td>• Decentralisation may result in divisions focusing on only those aspects that are beneficial for them. The decisions taken as a result may not be in the best interests of other divisions or the organisation as a whole.</td>
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<tr>
<td>• The authority granted to the divisional managers will be a motivational factor for them.</td>
<td>• This dysfunctional decision making can be prevented by not transferring all the authority.</td>
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The head office should maintain some power and authority. This will help them ensure goal congruence, encourage long-term views, provide feedback to the managers and increase their motivation to work in the best interests of the organisation.
2. Responsibility centres

- Divisionalisation of an organisation allows performance measurement through responsibility accounting.

- Responsibility accounting segregates costs and revenues into areas of responsibility, and a specific manager is made responsible for each area.

- This assigning of different aspects of the budget to different managers is known as responsibility accounting, and the area of operations assigned to a manager is known as a responsibility centre.

- Types of responsibility centres:
  - **Cost centre**: a responsibility centre where only costs are aggregated. The manager of the cost centre will be responsible for the costs under his charge.
  - **Profit centre**: a responsibility centre where not only costs but also revenues are accumulated and accounted for. Thus, the manager of this centre will be responsible for the profits of his area.
  - **Investment centre**: a responsibility centre where the manager will be accountable for costs, revenues and the investment decisions made. The manager is held responsible for both profits and return on investment.

- There can be several cost centres within a profit centre and several profit centres within each investment centre, each centre having its own budget and performance targets.

3. Controllability of costs

- Costs can be divided into controllable and uncontrollable costs.

- **Controllable costs** are those that can be influenced by the responsibility centre manager and usually include variable costs and directly attributable fixed costs.

- **Directly attributable fixed costs**: these are fixed costs that relate wholly to one particular responsibility centre.

- Although all variable costs and directly attributable fixed costs are treated as controllable costs in management accounting, they may not necessarily actually be controllable.

- Certain variable costs such as labour costs are **uncontrollable** in the short term because wages and salaries are mostly fixed.

- Costs can be classified as:
  - **Committed fixed costs**: costs that are controllable in the long run but cannot be controlled in the short run.
  - **Discretionary fixed costs**: fixed costs that can be influenced in the short term, for e.g. subsistence expenditure and advertising expenditure.
Both long-term and short-term costs should be regulated by the senior management.

**Indirectly attributable costs**

- There are certain costs that are not attributable to any one responsibility centre but are shared by the different profit centres.
- These costs should be appropriately allocated between them so that the responsibility centre managers are aware of the importance of other overhead costs and generate enough profits to cover them as well.
- However, these costs are not under the control of the responsibility centre managers.
- The apportionment of these costs may cause problems, as overhead apportionment is usually based on judgement.

**Illustration**

The following is a report for the profit centres of an organisation:

<table>
<thead>
<tr>
<th></th>
<th>Centre A</th>
<th>Centre B</th>
<th>Centre C</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>320,000</td>
<td>260,000</td>
<td>420,000</td>
<td>1000,000</td>
</tr>
<tr>
<td>Variable costs</td>
<td>170,000</td>
<td>100,000</td>
<td>200,000</td>
<td>470,000</td>
</tr>
<tr>
<td>Directly attributable costs</td>
<td>70,000</td>
<td>120,000</td>
<td>70,000</td>
<td>260,000</td>
</tr>
<tr>
<td>Controllable costs</td>
<td>240,000</td>
<td>220,000</td>
<td>270,000</td>
<td>730,000</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>80,000</td>
<td>40,000</td>
<td>150,000</td>
<td>270,000</td>
</tr>
<tr>
<td>Other Overhead Costs</td>
<td>(50,000)</td>
<td>(50,000)</td>
<td>(80,000)</td>
<td>(180,000)</td>
</tr>
<tr>
<td>Net profit</td>
<td>30,000</td>
<td>(10,000)</td>
<td>70,000</td>
<td>90,000</td>
</tr>
</tbody>
</table>

In this example, other overhead costs, i.e. indirectly attributable costs, have been apportioned to each profit centre. The results without including these costs (gross profit) are all positive, whereas the results after deducting these costs (net profit) show a different view.
4. Budget styles

**Top-Down (imposed / non-participative)**

The budget is set by the senior managers without involvement of the divisional managers. The targets set are communicated to various department managers and imposed onto the organisation.

This style has the following advantages:
- It is less time-consuming.
- The managers may not be fully capable of participating in the budgeting process.
- The top-level management can allocate resources appropriately due to having a better understanding and knowledge of the overall company.
- Senior managers are well aware of the long-term objectives of the company and thus can prepare a budget that helps fulfil those objectives effectively.
- The divisional managers may prepare a budget that is biased. They may create a *slack* in the budget to make it easily achievable.

**Bottom-up (participative)**

This approach involves divisional managers when setting the budget. Middle managers and other staff are invited to discuss the planned targets before they are set. This consultation process can result in more realistic budgets as well as improving the morale of the staff involved.

This style has the following advantages:
- These divisional managers possess in-depth knowledge of their division that the senior managers may be lacking. They can thus prepare more realistic budgets.
- The involvement of the managers will improve their morale and increase their motivation.
- Budgets prepared this way will be more acceptable and achievable.

5. Behavioural impacts of budget control

- Budgetary control systems will have varying impacts on the attitudes of managers.
- Control systems should be designed in such a way as to encourage positive attitudes that will be advantageous for the organisation.

**Budgets as targets**

- It is important, therefore, that targets are not too easy, causing disregard for budget figures, nor excessively difficult to meet, which can cause demotivation.
Good targets should be:

• Agreed in advance
• Dependent on factors controllable by the individual/department
• Measurable
• Linked to an appropriate reward system
• Representative of the company objectives to ensure goal congruence

Controllability

• It is important for employee motivation that performance measurements are based on controllable factors. Managers should not be held responsible for areas that are genuinely outside their influence, e.g. external price inflation or the costs of compliance with new regulation.

Behavioural aspects of budgetary control

A few unintended consequences that can occur when using budgets as a performance measure and a control mechanism:

Using more resources than necessary/ensuring all budget is spent

The budget-setting process could be seen as a competition for resources. There will be a tendency to feel that unless the budget allowance for one year is spent, there will be imposed reductions in the following year.

Making the bonus

A bonus system linked to budget achievement is intended to align employees’ personal goals (for higher income) with company goals. However, it can sometimes harm the company. This is because employees view the maximisation of bonuses as the main priority in any aspect of budgeting or work output.

Competing against other divisions, business units and departments

It may lead to poor attitudes in relation to transfer pricing of goods/services and a lack of willingness to co-operate on sharing information relating to methods, sources of supply, expertise, etc.

Providing inaccurate forecasts (budget padding)

Budget setters who are also responsible for the execution of the budget may be tempted to forecast exaggerated costs and downplay income in order to make budget targets easier to meet.

Meeting the target but not beating it

If there is no incentive to exceed the target, managers may not be effective enough and will just hit the target, while they could exceed it.
Avoiding risks

Managers are reluctant to take any risks in case they do not to hit the target. If they adopt a safe approach, they will hit the target, so why to take a risk and consider new opportunities? This can cause stagnation for the business.

6. Chapter summary