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*By Robert S. Kaplan*

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# The Demise of Cost and Profit Centers

*By Robert S. Kaplan*

**The Balanced Scorecard offers a previously unrecognized benefit: a whole new way of looking at organizational units. Specifically, observes Robert Kaplan, the distinctions between cost and profit centers are no longer significant. 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 early 1970s, as a young assistant professor of operations research at Carnegie Mellon University's business school, I was asked to learn how to teach the required accounting course. This worked out better than the dean or I might have expected. Soon I graduated to teaching MBA electives in management accounting—and faced the need to expand my knowledge of management accounting theory and practices. I came across a text and case book entitled *Management Control Systems,* written in 1965 by three Harvard Business School faculty members: Robert Anthony, John Dearden, and Richard Vancil.[1]

*Management Control Systems* (herein, "MCS") contained an exciting new approach to describing different decentralized organizational units. It examined the relationship between the design of decentralized organizations and the motivations of and incentives for those who manage them, based on the metrics used to measure the units' performance. 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; and their quality level, price, and 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 such 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 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 marketing or sales unit, has the responsibility for selling the finished goods produced by a manufacturing division (a standard cost center) or the products offered by a service organization. Because a revenue center generally 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 salespeople 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 responsible for advertising and promotion, are usually treated as discretionary expense centers. The output from these units is not easily measured

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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.

**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.**

The MCS taxonomy reveals that decentralization can take many forms—a compelling discovery. And the management control systems course I taught based on this framework was a wonderful teaching—and learning—experience. Students analyzed cases of actual organizational units and debated which organizational form was most appropriate for the unit. The discussion, of course, took place within the traditional financial control paradigm dominant through the 1970s (and prevalent well into the present), which used only financial metrics—cost, revenue, gross margin, profits, or ROI—to motivate, align, and reward decentralized operating and support units.

### The Balanced Scorecard Revolution

When Dave Norton and I introduced the Balanced Scorecard in the early 1990s, we described the limitations of financial metrics such as profits and ROI in 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 and for motivating them to create long-term value. We contended that the performance of such managers must be measured by 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. By linking their activities to strategy execution, all units become, in effect, strategic business units. Let's see how as we examine each in turn.

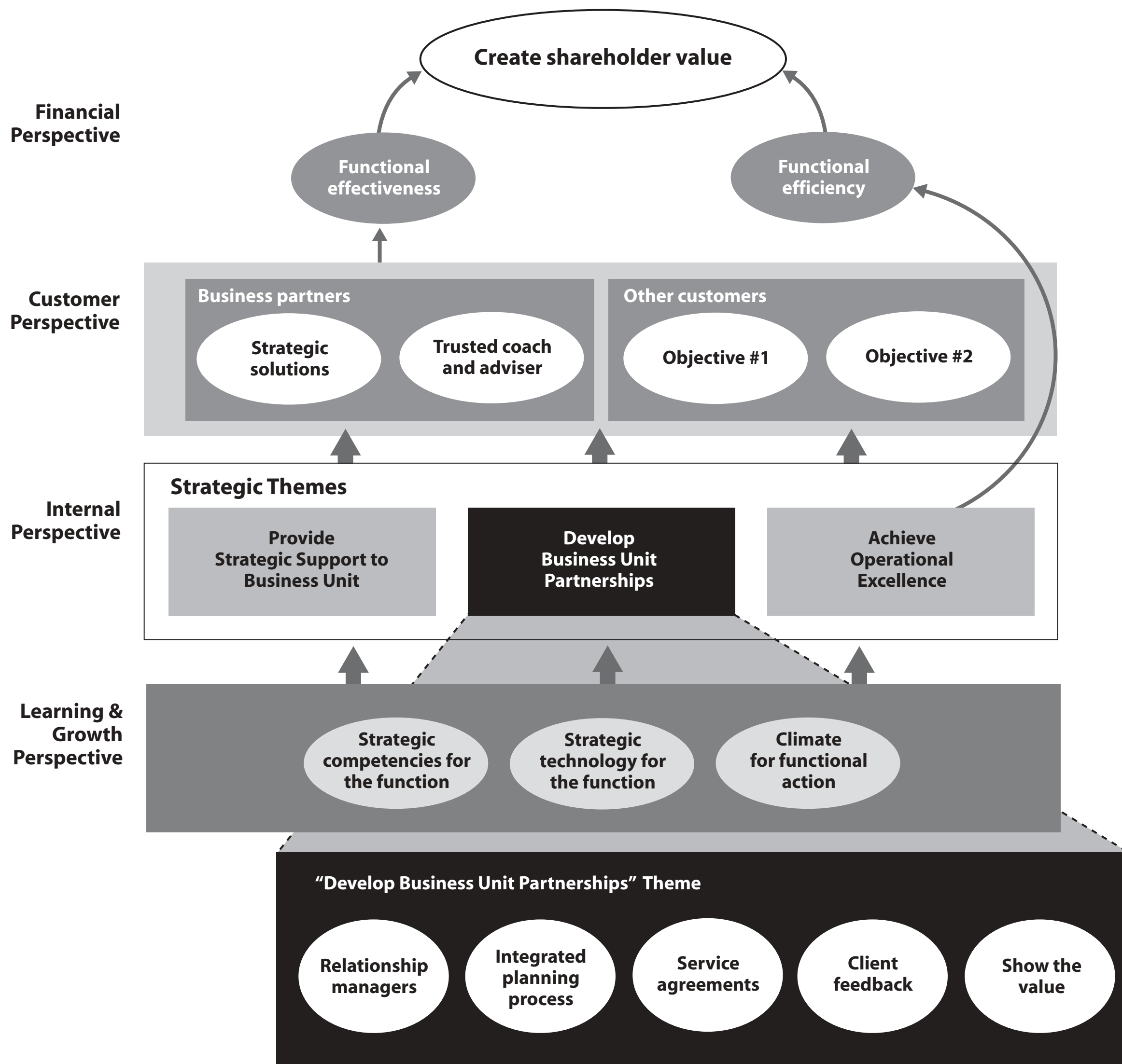
### Transforming the Cost Center

Empire Glass[2] was one of the most provocative cases I taught from MCS. The Empire Glass company treated a manufacturing plant that had no authority for pricing, marketing, or sales activities—a classic cost center—as a profit center. The class discussion 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. 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. The profit measure helped the manufacturing manager appreciate how his plant contributed to current and future sales. If he were to be evaluated only by how much he beat the standard cost budget for the actual volume and mix of products demanded, the plant manager might instead 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.

**What a revolution! The plant is neither a cost nor a profit center; it is a strategic operating unit whose alignment with company strategy can be comprehensively visualized, measured, motivated, and evaluated.**

While the thinking behind such a decision seemed reasonable at the time, we now understand that forcing a plant such as the Empire Glass plant to be a profit, rather than a cost, center was a suboptimal 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 would instead ask students

***Figure 1. Generic Support Unit Strategy Map***




*The BSC, in tandem with activity-based costing, can help discretionary expense units be measured in the same way as traditional profit, revenue, and cost centers—and enable them to become strategic business units in their own right.*

to construct a strategy map and Balanced Scorecard for the Empire Glass plant. The primary financial metrics would include a 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 the 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 be comprehensively but succinctly visualized, measured, motivated, and evaluated.

### Revisiting the Revenue Center

Let's next consider the revenue center, which has 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, for customer satisfaction and loyalty, and for 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-sales 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 raise 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 to achieve promised levels of customer service. 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, cost-to-serve for key customers, 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.[3] Companies can now use profits, not just sales, to measure the performance of their marketing and sales units.

**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.**

### The New Discretionary Expense Center

Perhaps the greatest breakthrough in measuring, evaluating, and motivating 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. (See *Figure 1*.) 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 connect their expenses 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, performance management appraisals) and IT (providing CPU capacity, storage capacity, and connect time). The ABC innovation enables these resource costs 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 of breaking 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. Now, every corporate support unit can be treated not as a discretionary expense center—not even as a break-even cost center—but as a strategic business unit in its own right. How can an organization accomplish this dramatic transformation?

Starting with the financial perspective, the organization 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. The organization 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.

Support units must understand their internal customers' strategies and align their service offerings to contribute to their customers' success, just as operating units do with their external customers. 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 customer feedback. Just as they might employ revenue and profit metrics in their scorecard's 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.

**Support departments should constantly strive to lower their costs and raise the quality of their services. But they should not stop there—they should identify the processes that enable them to become trusted advisers to operating unit leaders, helping the leaders achieve their differentiating strategies.**

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; it also offers 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—such as operating the general ledger and accounts receivable function (finance), the compensation and benefit system (HR), and the computing and networking infrastructure (IT)—are nonetheless vital. 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 become trusted advisers to operating unit leaders and help those leaders 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 it 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.

## Make Every Unit a Strategic Business Unit

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 on 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. ■

1. R. Anthony, J. Dearden, R. Vancil, *Management Control Systems* (Richard D. Irwin, 1965). At the time I could not have imagined that 13 years later, all three would be my colleagues. The book is now in its 12th edition.

2. *Empire Glass Co.* (A), Harvard Business School Case, by David F. Hawkins (April 10, 1964: 9-109-043). The case, written by my HBS colleague, is still being taught in many business schools.

3. R. S. Kaplan and S. R. Anderson, "Time-Driven Activity-Based Costing," *Harvard Business Review* (November 2004): 131–138. Kaplan and Anderson's new book on the subject is due out from Harvard Business School Press in the spring of 2007.