Cost and Profit Centres

Specification requirement— The nature and purpose of cost and profit centres.

Cost Centres

Cost centres can be divisions, departments, outlets, or even individual products within an organisation. A cost centre is created when overhead costs are directly allocated or apportioned to divisions, departments, outlets or individual products. A retail firm with 20 outlets may operate each one as a cost centre, a manufacturing company producing 10 products may operate each product as a cost centre. The basic motive for establishment of costs centre is that the allocation of overhead costs, such as advertising or transport, to each of these cost centres, allows the profitability of the cost centres to be judged. Once profitability is accurately known, then informed decisions on investment, product range management, marketing etc, can be made.

Profit Centres

Profit Centres take the basic idea of Cost Centres somewhat further. In this case, a Profit Centre is run as a separate business within a business. The Profit Centre will buy services from other divisions and profit centres within the parent organisation, and then selling their output on to the final customer or to another part of the parent organisation. The profit Centre will have its own profit and loss account and bid for investment capital from the parent company.

In recent years there has been a huge growth in the development of Cost Centres and Profit Centres within large organisations. There are several reasons for this growth and most of these can be linked to personal motivation and more effective control.

Typical examples of Cost Centres are many branches of Building Societies and Banks. In these cases all costs are allocated to a branch. So for example, the branch will be charged for the brochures it uses, its wage bill, its telephone costs, and it will be apportioned part of head office costs. The effect of this is to encourage cost savings and to motivate staff into action that will improve the financial performance of their own office. The overhead costs allocated can often be linked to the income earned by each branch, and therefore profitability' of each branch can be judged.

As we have already seen Profit Centres take the idea of overhead allocation further; in this case each division of a large business is run as an independent business., with it's own profit and loss account. An example of an organisation operating Profit Centres is Corus (formerly British Steel). Within Corus the Tin Plate division operates as a Profit Centre. Corus Tin Plate buys services and goods from within the organisation, and sells output to other divisions and to external customers.

You may also find that Profit Centres will trade with other organisations. A good example of this happening can be found in Local Authorities Direct Labour Divisions. These are a part of a local authority, who's role is to provide services such as repairing buildings, cutting grass etc. But apart from contracting to provide these services to the local authority the Direct Labour Division will also bid for other contracts from outside the authority.

Advantages and Disadvantages of Cost and Profit Centres.

Advantages of Cost Centres

- Motivation of staff, who feel committed to cost centre
- Improved monitoring of costs and expenditure
- Improved management information on profitability
- Improved monitoring of investment returns

Disadvantages of Cost Centres

- Incorrect allocation of overheads can lead to under or overestimation of profitability
- Increases administration and paperwork

Advantages of Profit Centres

- Allows decision-making and power to be delegated effectively.
- Improves speed and efficiency of decision making.
- Increased motivation - now working for a smaller, more local business.
- Allows more effective use of bonuses and other forms of financial motivation - all linked to profitability of profit centre.

Disadvantages of Profit Centres

- Loss of overall central control of the company
- Profit centre could be working towards different or non-company agendas.
- Increased opportunity for empire building by management.

Overhead Allocation.

Overhead allocation is a key aspect of the use of cost centres. Overheads are costs not directly generated by the production process. Many firms wishing to discover the true costs of producing a good will allocate these costs to a department or cost centre, where they are added to the direct costs of production. For example the cost of employing receptionists could be split amongst departments, or even allocated to a specific product. The main problem with allocation of overhead costs is that most methods of allocating these costs are arbitrary (based on personal preferences), and run the risk of distorting the true cost of producing a good.

For more on overheads and costs see chapter on Costing

Notes.