

PART 3: EVERYONE IS RESPONSIBLE

3.1. Assign responsibility

Who in your head office is responsible for telephone costs or electricity costs?

Results must be expressed as the responsibility of individuals.

When we set budgets, we make each department head responsible for meeting their budget goal. But businesses sometimes pay lip service to the responsibility accounting principle, without implementing it properly. Sometimes nobody is really responsible for a cost that is spread across the organization, like telephones or rent. Alternatively, supervisors may be held responsible for an item that they really cannot control. Proper responsibility accounting requires top management to make someone responsible for every controllable item in the organization. These persons are then required to set budgets for their areas of responsibility, have them approved, and operate within the targets they have set themselves. For effective control, every cost and revenue line in the budget must be someone's accepted responsibility. The individual must also have the authority to initiate action in regard to the particular item, if it is required. You cannot have responsibility without authority.

Case study

"I want to see a name next to every line on the expense report"

Some years ago a project team was set up to look at the planning, budgeting and reporting in one of South Africa's largest supermarket chains. At the end of the project, the managing director said that the biggest single benefit arising from the review, had been the **Principle of Responsibility Accounting**.

"I can walk into any store in the country, take the expense report, and go through it line by line. I'll say to the staff "Who, in this store, is responsible for telephones? "And a hand will go up "Me, sir! " And for stationery? "Me sir!"

There is a name next to every line in the expense report. The person could be a till supervisor, a security manager or a buyer. But in addition to their ongoing duties , they are challenged to take responsibility and think about a particular cost – such as maintenance of refrigerators – and come to the management meeting and tell us how we must all work together to manage and control those maintenance costs. We call these people "champions". You will hear someone say "I am the champion of telephones". The only hand that never goes up is the store manager. In our business, a particular cost may be running below budget, but the champions monitor it just as carefully as though it was way over budget. Cost management is a key success factor in this business, and we have

thousands of staff members – our champions - thinking about their cost project all the time. “

3.2. Build the right organization structure

If you have a weak or wrong organization structure, your budgetary control system will break down, because the responsibility accounting principle cannot be applied.

Some symptoms of a poor organization structure are:

- Too many people reporting to one person.
- People having more than one boss, or no specific boss.
- Unclear job descriptions and objectives.
- Wrong personality or skills to do the job, e.g. introverts in positions requiring extroverts or people not qualified for the position.
- People reporting at too high or too low a level in the organization.
- Unclear distinction between line and staff functions.

The task is to build a structure to make the strategy happen. Select the **right people for key positions** and build the **structures that allow people to act**.

3.2.1 The right people.

20% of your people deliver 80% of your profits. Find those people, nurture them, train them, and give them opportunities to grow and reward them when they do. They will solve the product-market problem for you. Conversely, the wrong people will compound the chances of failure. Ensure that your best people are put in charge of your key success factors - the tasks that are most critical for the organisation's future.

“Every year we’d ask each of **General Electric’s** businesses to rank all their top executives. The basic concept was we forced our business leaders to differentiate their leadership. They had to identify the people in their organisations that they consider in the top 20%, the vital middle 70, and finally the bottom 10%. If there were 20 people on the management staff, we wanted to know the 4 in the top 20 and the 2 in the bottom 10 – by name, position and compensation. The under performers generally had to go. “

Source: Jack Welch, CEO, General Electric “JACK” Headline Publishing 2001.

3.2.2 The right structure

Structure evolves as the organisation grows. The typical structures at each stage of development are:

Small single business:	- centralized functional structure
Geographic spread or broad product categories:	- divisional structure
Vertically integrated firms:	- divisional structure
Diversified group:	- decentralised structure

An important part of deciding on structure is where the authority for key decisions should reside. As an organisation grows, parts of the business become too big for one person to manage and need to be split. It may be the right time to set up a fast growing new project, product category or geographic market as a separate business.

Organisation design also considers the role of each unit and department. The structure should be built around the strategy-critical business units that play a vital role in achieving the strategic thrusts. Departments that carry out routine operations and provide administrative and support services should report to separate managers.

“Structure follows strategy”- Alfred Chandler

3.3. Choose your responsibility centres

3.3.1. Choosing the right measure

An important part of responsibility accounting is to set up the right kinds of responsibility centres. The financial performance of any department, business unit, branch, section or division in an organisation can only be measured in one of four ways. Top management must choose which of these four measures – known as cost, revenue, profit and investment centres – to use, so that responsibility for the control of each revenue and expense item can be given to individual managers, and the managers will be motivated to behave in the best long-term interests of the business.

In many cases the choice of responsibility centre is self evident. In other cases the choice made can have a direct influence on the department and its future development. Service departments such as the IT department, for example, can be asked to charge their services to users at commercial rates (a profit centre), or to operate as a cost centre. A steelworks like Iscor must choose whether to transfer cast ingot to its rolling mills at cost or at a profit.

3.3.2. Types of responsibility centres

A cost or expense centre is one where we measure the costs only. We budget for the costs, and attempt to come out at or below budgeted cost. People managing cost centres tend to be cost-conscious, anti-spend and conservative.

A revenue centre is similar to a cost centre, except that only revenue is measured. A typical example is the sales budget for a branch sales office.

A profit centre makes the manager responsible for sales and costs by measuring profits. We would expect profit centre managers to be more entrepreneurial, spending money where they can see medium term benefit. People who are treated as profit centres rather than cost centres tend to:

- Stay longer in their jobs.
- Be the innovators in their organizations.
- Exhibit more motivation and job satisfaction.

Investment centres. A profit centre manager might over-invest in working or fixed capital in order to optimise profit. So individual factories, branches, divisions and regions are usually measured as **investment centres** i.e. on the Return on Investment they achieve. A bonus system for this type of centre usually sets a target ROI and rewards the manager for achievement above this level.

3.3.3. Motivating behaviour

The way in which managers behave depends on what is measured and how it is measured in the organization. Managers of cost centres are cost averse whereas a profit centre manager will spend over budget if a greater improvement or saving can be made. People try to deliver the things that are Measured.

The criteria for deciding what kind of centre a particular department are not clearly defined. The size of each operation, the level of investment, and the

ability to measure both profit and investment with accuracy, are influencing factors. What is the correct choice to motivate managers to behave in the best long term interests of the business?

Benefits which may arise from converting cost centres to profit centres are:

- Speed of operating decisions may be increased – don't have to refer to head office.
- Quality of decision making improves – made where the action is.
- Head Office relieved of operating decisions – can concentrate on strategy.
- Profit orientation of managers may improve.
- Performance measurement is based on bottom line – more real world.

Possible problems which may arise from converting cost centres to profit centres:

- Head office may lose a degree of control.
- Competent profit centre managers may not be available.
- Units that were co-operating may now compete with each other.
- Friction may arise – transfer pricing, sharing of jointly generated costs and revenues.
- There may be too much emphasis on short-term profit making which in turn may hold back on maintenance, training, research and development – especially where unit managers are regularly transferred and promoted.
- There is no guarantee that if each unit tries to optimise their own profits that group profits will be optimised.

The budget process should set targets for each responsibility centre that will lead the manager and staff to act in the best long-term interests of the business as a whole.

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