
Course Learning Outcomes for Unit VIII

Upon completion of this unit, students should be able to:

2. Apply accounting concepts to the creation of accounting information and reports.
 - 2.8 Calculate performance measures used to make business decisions.
 - 2.9 Present findings of accounting reports used in business decisions.

4. Discuss how the application of accounting knowledge is used in a leadership role
 - 4.2 Identify the importance of responsibility accounting in leadership.

Required Unit Resources

Chapter 12: Decentralization and Performance Evaluation, pp. 12-1 – 12-23

Unit Lesson

Introduction

Welcome to the last unit, Unit VIII. We will be discussing performance evaluation techniques, including the advantages and disadvantages of decentralized organizations in terms of cost controls, return on investment, and the balanced scorecard approach.

Decentralization

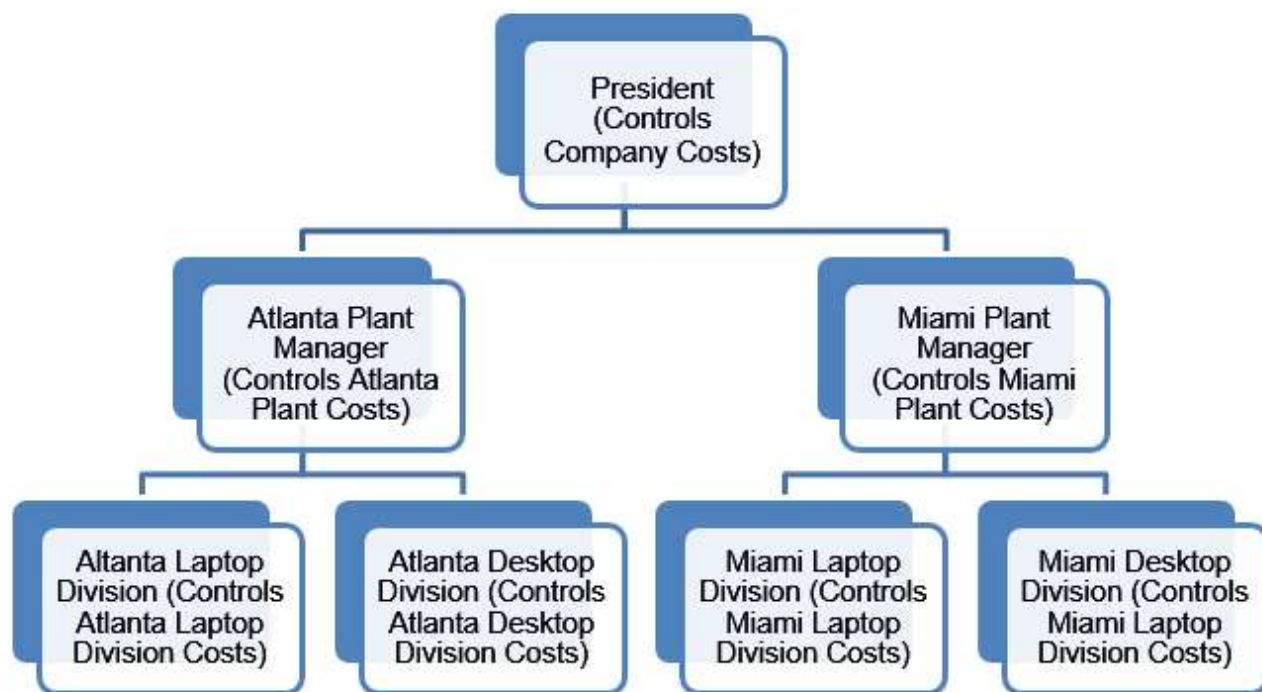
Decentralization within an organization allows managers more authority to make decisions for their units. There are advantages and disadvantages to this approach to decision-making. The advantages of a decentralized organization include: quicker response times to issues and more detailed information for the division managers that just highlights of their area. For example, using our computer company example with two divisions, the manager of the laptop division would be able to gather information about production for just this one division and make a decision quickly regarding the approval of overtime for the division. The laptop manager would not have to wait for an approval from the factory manager who would be busy with issues for both the laptop and desktop divisions. In addition, giving the division manager more authority to make decisions may also motivate the manager to run the division more effectively and efficiently since he or she has more authority to make decisions independently. Finally, in decentralized organizations that allow division managers to make decisions that affect their unit can allow them to transfer these skills as a way to train division managers for higher level management jobs within the organization since they are used to making their own decisions (Jiambalvo, 2020).

There are also some disadvantages of a decentralized organization. For instance, there are often duplicate tasks performed. In our computer company example, both the laptop and desktop computer division would need their own purchasing departments and sales forces since each division is only handling their own division. The other main disadvantage to a decentralized organization is that the goals of the individual divisions may be in conflict with the company-wide goals. For example, one division may want to aggressively expand the division, which may not be what is best for the company as a whole.

Responsibility Accounting

Under the concept of responsibility accounting, each level of management is responsible for what they can control. In other words, a lower level manager at the computer manufacturer's Atlanta laptop division would not be able to control the cost of all of the factory's overhead but would be able to control the cost of overtime

pay in the individual department. Looking at the chart below, you can see where each level of management has responsibility over different costs.



Cost Centers, Profit Centers, and Investment Centers

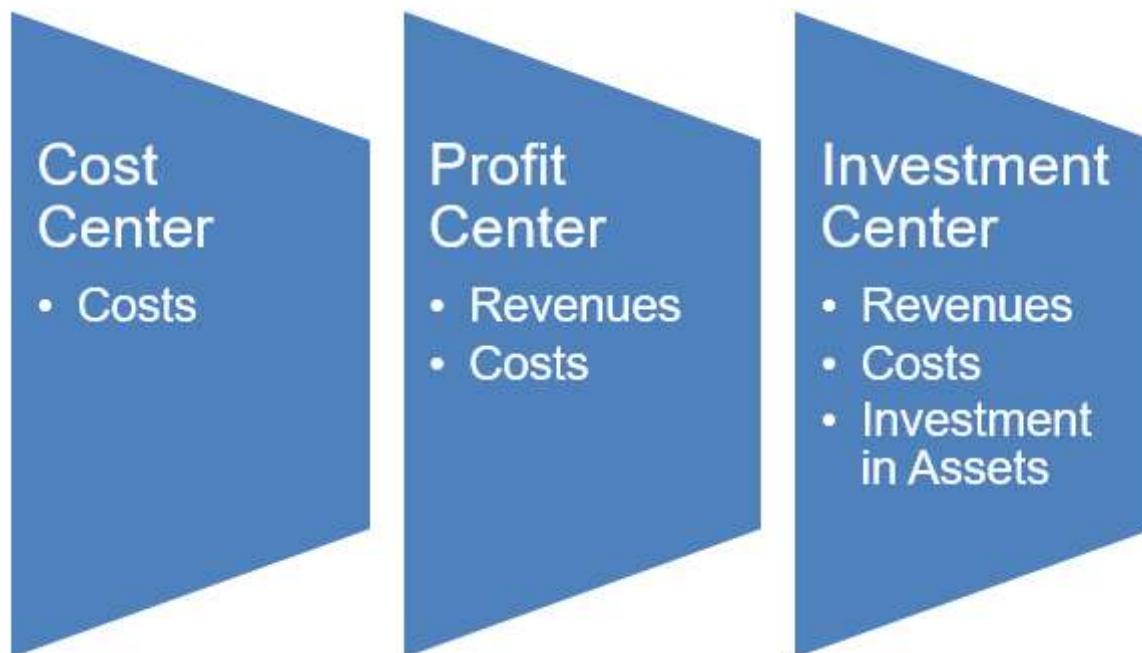
Now that we have talked about the responsibility for controlling costs at various levels of management, we will be discussing how this relates to the concept of center costing. Starting off with *cost centers*, this refers to the idea that only costs are controlled by the manager. These costs could include machine maintenance, supplies, or direct labor costs. Therefore, the manager is responsible for ensuring costs are as low as possible while still maintaining quality when producing a product or providing a service. For example, the manager at the Atlanta laptop division would control and review the costs for materials used and labor costs only within his or her division. To see how well the manager is controlling these costs under the cost center approach, the main evaluation technique would be based in variance analysis, where the manager would look at the actual cost of material and labor for the division and compare that to the standard or budgeted costs for material and labor for the division. Any variances that were discovered would be investigated to see how improvements could be made in the future.

Profit centers refer to managers controlling both costs and revenue. For example, a plant manager would be responsible for the sales that could be generated by the plant, less the costs to run the plant. Using this technique, the Atlanta plant manager would look at the total revenue generated by the sale of computers (both laptops and desktops) and also look at the costs associated with running the Atlanta plant as a whole. To see how well this Atlanta plant manager is controlling these costs under the profit center approach, the main evaluation technique would be based on net income for that plant. The manager would look at the actual net income for the plant and compare the net income to the budgeted amount for that plant location. Any differences that are discovered would be investigated to see how improvements could be made in the future so that the plant as a whole is meeting net income expectations.

Finally, *investment centers* not only look at costs and revenue but also how well assets are being utilized. This technique could be used, in our computer company example, at the plant level or at the company level. For example, if the Atlanta plant manager is able to decide on which equipment to purchase for their particular plant, the investment center approach could be used. The manager would not only look at revenue and costs for the division but would also determine if the equipment they have purchased for their plant is producing a return on the investment they made to buy that particular equipment. However, if all of the equipment is only

purchased at the top level of management, by the president of the company, for both the Atlanta and Miami plants, then the investment center approach would be based on the company as a whole rather than on each division. The way the profit center is evaluated is based on return on investment, which is the income divided by the investment (Jiambalvo, 2020).

The chart below summarizes the concepts of cost, profit, and investment center approaches.



Return on Investment

Return on investment not only looks at how much income is being produced but also how an investment in assets is being utilized. For example, let's say the Atlanta plant and Miami plant both made \$50,000 in income last year and both purchased new equipment for their plants. At first glance, it appears that both plant managers are doing equally well. However, now we will factor in the cost of the equipment. The Atlanta plant manager spent \$500,000 on their equipment, and the Miami plant manager spent \$1,000,000 on their equipment.

Atlanta = $\$50,000 / \$500,000 = 10\%$ Return on Investment
Miami = $\$50,000 / \$1,000,000 = 5\%$ Return on Investment

Therefore, when we factor in the cost of the equipment purchased, the two divisions are no longer equal in their performance. While income may be the same, the return on the investment in Atlanta is 10% but the return on investment in Miami is half of that at only 5%. This means that the Atlanta plant is using the equipment more efficiently (Jiambalvo, 2020). In other words, both divisions generated the same amount of income, but since the equipment cost much less at the Atlanta plant, it has a higher return on the investment that it made in the equipment.

Balanced Scorecard

The means of assessing performance that we have looked at so far are all calculated based on the past performance. For instance, we look at costs spent, revenue generated, and even money already spent on equipment. These approaches do not look at what is going on now and how a manager can create future value.

The balanced scorecard approach looks at four performance measures, where the financial performance is just one of the four elements. The other three elements include customer perspective, internal processes, and learning and growth. All of these elements are combined to develop a strategy for future business success.



Now that we have identified the four components of the balanced scorecard approach, we will look at each in detail. On the *financial* side, we look at how well the company is achieving its financial goals. This may include calculating net income, return on investment, and cash flow. Next, we look at how well the company is satisfying *customer expectations*. This may include rating customer satisfaction, calculating customer retention, or even determining how many new customers were acquired. Next, we look at *internal processes*. This section looks at things like calculating turnover rates for materials and inventory, determining how much time it takes to fill an order, and even determining the number of defective products produced. Finally, we look at *learning and growth*. This includes calculating how much money is spent on providing training to employees, determining employee retention rates, and identifying the number of new products introduced into the market (Jiambalvo, 2020).

Once the company has identified what it wants to measure, it then needs to determine how it will measure that item. For example, if our computer company wants to measure customer satisfaction with their new laptop purchase, the company could develop a customer survey that could measure how customers feel about the product they just purchased by rating the satisfaction levels. Another example may be that if the computer company calculated a high defect rate while looking at its internal processes, then it may want to calculate how much money was spent on employee training in the learning and growth category. This may

produce a correlation between the high defect rates, and maybe not enough money spent on employee training; so, in the future, the company can lower the defect rate by providing additional training to employees.

Conclusion

In this unit, we have looked at various ways to evaluate management performance based on the concept of decentralization and responsibility accounting. In other words, we allow managers to make decisions based on the level of responsibility they have within an organization. The higher the level of management, the more responsibility they have to control company-wide costs. We also discussed the idea of cost, profit, and investment centers as a way to ensure various levels of management are being evaluated on what they can control in terms of costs only, revenue and costs, revenue, costs, and return on investments. Finally, we discussed the concept of a balanced scorecard approach where a manager's evaluation was not solely based on financial data but also takes into account customers, internal processes, and learning and growth.

Reference

Jiambalvo, J. (2020). *Managerial accounting* (7th ed.). Wiley.
<https://bookshelf.vitalsource.com/#/books/9781119577706>

Suggested Unit Resources

View the following video by accessing the Unit VIII Additional Unit Resources folder in the unit.

The video *Southwest Airlines: Balanced Scorecard* will discuss how the use of the balanced scorecard technique is used to evaluate performance.

You can access a transcript for this video by hovering over the PDF button at the bottom of the video and then clicking on the word "Transcript." Alternatively, you can click on the "cc" button at the bottom of the video to turn on closed captions.

Learning Activities (Nongraded)

Nongraded Learning Activities are provided to aid students in their course of study. You do not have to submit them. If you have questions, contact your instructor for further guidance and information.

After watching the video in the Suggested Unit Resources, you may want to view the Chapter 12 Flash Cards found in the Additional Unit Resources folder to reinforce the material presented in this unit.