

**UNIVERSITY OF BAHRAIN
COLLEGE OF BUSINESS ADMINISTRATION**

**MANAGEMENT CONTROL SYSTEMS
THROUGH PROFIT CENTRES IN
BAHRAINI ORGANIZATIONS
(MBA PROJECT)**

**BY
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ADVISOR: Dr. T. CURSOY

**READER: Dr. MUSTAFA KHAN
READER: Dr. NUSRAT QURESHI**

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ABSTRACT

The aim of this report is, first to examine the validity of the use of profit center concept as part of management control system through extensive examination of the existing literature. Second, to study the organizations established in Bahrain in order to examine their approach towards such a concept. Information were obtained from various organizations in various industries.

The result of the literature study was that the use of profit centers in well diversified, or geographically distributed organizations is a necessary act to make control possible.

However, it is established that proper implementation requires adequate Management Information System and management style.

All the organizations studied, have made an attempt to use profit centers as part of management control system, yet, with differing success levels. Yusif Bin Ahmed Kanoo, Arab Insurance Group and Standard Chartered Bank presented the best examples for the use of such concept with some modifications to be desired in them.

On the other hand hotels and most banks were poor examples of profit center implementation .

My conclusion is that the first step needed to be made in organizations in Bahrain toward more successful divisionalization into profit centers is a change in the attitude of the management society. This by no means is directed solely toward Arab nation-

alities since a number of top managers in organizations under-study were expatriates. Relationships play a heavy part in Bahraini organizations which is an indication of lack of professionalism.

1-INTRODUCTION

1.1-Purpose

The purpose of this research is to carry out an empirical research regarding the use of profit center concept as a management control tool in Bahraini organizations, and to compare the existing situation with available literature.

1.2-Scope and Limitations

The theoretical part of the report is tried to be as comprehensive as possible. However, the empirical part emphasizes on the managerial aspect more than the accounting aspect of the profit center concept implementation.

1.3-Sources and Methods of Collecting Data

Primary Sources of information were reached through questionnaires and, when possible personal interviews. The questionnaires were distributed in the following organizations: Bank of Bahrain and Kuwait, Standard Chartered Bank, Gulf Hotel, Regency Intercontinental Hotel, Arab Insurance Group, Northern Assurance Co. Ltd., Bahrain Aluminium Company (BALCO), Ysif Bin Ahmed Kanoo, Bahrain Maritime and Mercantile International B.S.c. (BMMI), Gulf International Bank, Bahraini Bank of Oman, A.B.N. Bank, Al-Ahli Commercial Bank, ALBA and Diplomat Hotel. The questionnaire is presented in Appendix 1. 15 personal interviews were carried out with managers in the first eleven organization.

70 questionnaires were distributed with 78.9 percent response rate. Unfortunately from these only 36 questionnaires (51% of total) could be used. Since 90% of managers interviewed requested that their names be excluded from the report, I decided not to include any name.

The existing crises due to Iraqi invasion of Kuwait has caused an emergency state in most organizations and causing most expatriates to leave the island. This has been the main reason for lower response rate from questionnaires distributed than expected. And it has caused difficulty in securing more interviews with managers.

2-LITERATURE SURVEY

2.1-Management Control Systems

It has always been known that as soon as a group of people (more than two) come together for any reason, there must be somebody in charge to direct the activities. In fact, members of the group themselves seek this leader in order to avoid confusion and gain a sense of direction. It does not matter why the members have joined the group. It could be just for socializing and having fun or for something more serious like carrying out a business mission. Whatever the reason, members demand a clear definition of the objectives and everybody is expected to conform to the group norms and beliefs.

The situation is exactly the same in business organizations. A group of people come together to produce a collective effort toward achieving some goals that are shared by all members. Beside the shared goal each member of the group has certain personal objectives for joining the organization. This could be a monetary objective or something more abstract such as status, self-esteem, the feeling of belonging and so forth.

At this point the need for a controller is shared by everybody, but to different degrees. The controller is to direct their efforts, set the objectives, receive feedback from them regarding their performance, reward them, and help them to internalize the organizational goals. Members of the organization are to believe

that it is only by achieving the goals of the organization that they can achieve their more personal goals.

The degree of awareness of organizational goals differs highly by the level of the member in the organization hierarchy. A man working in the production room hardly knows and cares about the organization's overall objectives. For him the goals and standards set by his immediate manager are important. In fact he does not need to know the organization's objectives in details, since these are broken down to operational elements and given to him in the form of production standards and schedules. The reward he looks for is mostly in monetary terms, the feeling of belonging, and a sense of security by having a job. The kind of control that is imposed on him is normally different from those imposed on his boss, due to the nature of work.

What is control? Following are some definitions by different authors. The wordings might be different, but the essence is the same.

Buchele defines control as "The process of measuring actual results, comparing those results to plans or some standards, diagnosing the reasons for deviations of actual from desired result, and taking corrective action when necessary."¹

He continues that for a successful control, plans and standards should be reasonable; Not too low, making them too easy to achieve and offering no challenge. Not too high to be

discouraging making people believe that it could never be achieved. Most authors suggest that a 50 percent chance for hitting the target is the desired probability distribution. Some go further and find less than 50 percent chance of goal achievability more motivating. Dunbar says that budget target should be set so that they are achievable between 25 percent and 40 percent of the time.² However, new findings are inconsistent with conventional theories. In a research carried out by Kenneth A. Merchant and Jean-Francois Manzoni, actual budget achievement of profit centers of 12 corporations showed different pattern of behavior.³ Of 45 profit center managers 39 gave a probability of 75 percent or higher for achieving their target. 24 reported a chance of 90 percent or greater for achievement. Only 3 managers believed that they had less than 50 percent chance to achieve their target.⁴

More surprisingly 29 out of 39 profit center managers exceeded their targets and this over achievement was not limited to one year's performance, but some showed consistent over achievement over years.⁵ However, it should not be concluded that these profit centers had an easy target budget to achieve. As the researchers described, it could be said that "targets were challenging, but very likely to be achieved by the profit center management team if they exert a consistently high level of effort."⁶

These results obviously have important organizational implica-

tions.

There is a two way feed back between planning and controlling. Plans specify areas that need more control and a proper control system will identify areas that a modification or change in plans is desirable.

Anthony, Dearden, and Bedford in 'Management Control Systems' define control as follows: "Control is the process of guiding a set of variables to attain a preconceived goal or objective. In organizations it includes various planning and controlling processes. A substantial part of these processes takes the form of management control: the actions used by management to guide people, machines, and functions to attain organizational goals and objectives ."7

Each and every function of the management need a continuous control. The feed back mechanism is very important as it provides the necessary information for management control. Information could be gathered through formal or informal channels of communications. Formal reports provides the management with information regarding a specific position, and allows formal evaluation of the situation. However, informal channels most of the times give management insight to situations that are more useful and important than those provided by formal report.

Management here as well should take care to be selective in gathering information and does not allow individuals to take advantage of the situation to their benefit. The most important

constituent of a good management control system is a good management information system (MIS). It will be informative as well as preventive. Management control system is most effective when it can prevent the failure of plans or reduce the loss of those plans that have no chance of revival.

As mentioned before the amount of control exercised in different levels of the organization differ tremendously. Yet, the top management's philosophy regarding control will be the determining factor in the type of control to be imposed throughout the organization. However, as the organization expands, change becomes inevitable. Sole proprietorship gives way to partnership and partnership is replaced by corporation. In the processes of these changes centralization of authority also should give way to decentralization. This is the only way that the organization can continue to be efficient and effective and deal with specialized areas expanding in the organization. Otherwise there will be a duplication of efforts, yet, deterioration of efficiency and effectiveness.

The nature of control changes and top management has to control the performance of different units that mostly work on their own command. The manager of each unit also has to use different control system as his authority and responsibility increase. Up to five or six decades ago control perhaps only meant strict budgetary control and accounting reports, but now computerization has given a new meaning to management control and management

control systems. Computers allow human-interface programs and real time reports. This will provide management with information as events are happening. There is no need to wait days and weeks for reports to be prepared only to give data when it is too late.

Establishing responsibility centers as a part of management control system is aimed at enhancing the delegation of authority and responsibility. The level of delegation to the managers of these centers depends to the level of integration between the organization's units. The higher the integration the more difficult the divisionalization will be. Functional divisionalization introduces such difficulties. In these type of organization each step of product development is carried out in different responsibility centers. One is responsible for design, the other for production and yet another one for marketing it. Care should be taken that the management control system allows for fair distribution of costs and revenues among the divisions. These are transfer pricing problems which will be dealt with in another section in correspondence to profit centers. In this respect MIS is to gather, scan, and report information to the top management. The control system should make sure that only relevant information are collected as gathering information is a very costly activity, and irrelevant information tend to distract management attention from the problem areas.

There are considerations when structuring a control system for an organization. Anthony, Dearden, and Bedford specify three areas to be looked in .⁸ One is the study of internal and external

environments and their effect on the control procedures of the organization. For one thing, if the external environment relevant to the organization changes rapidly, closer controls with shorter intervals are needed to detect deviations and misfit of organization's plans with external environment. The second issue is the extent of the organization's tendency or of its parts, to go out of control. Factors effecting this tendency are: employee's characters, span of managers' responsibility, quality of leadership, organizational structure, the level of job clearance to the employees, nature of the production process, and sensitivity of the organization to external events. An organization that has a high percentage of young managers who are high risk takers need a different control system than one with managers that have been on the same job for relatively longer period and are low risk takers. This in effect is influenced by the risk taking quality of the top manager. Also employees that know their job clearly, need lower level of control. The sensitivity of the organization or parts of it to external events is a very determinant factor. For example a dealing room of a bank is obviously faster and more affected by political movements in the external world than a shoe manufacturing company.

Another factor deciding the control system in an organization is the available control devices and techniques internally and externally. A human-interface computerized system can bring the deviations to management attention very quickly.

Clive Emmanuel and David Otley in their book "Accounting for Management Control" define four necessary conditions before any system can be said to be controlled. "First, objectives for the process being controlled must exist, for without an aim or purpose control is meaningless. Second, the output of the process must be measurable in terms of the dimensions defined by the objectives. That is, the degree to which the process is attaining its objectives must be assessed. Third, a predictive model of the process being controlled is required so that the causes for non-attainment of objectives can be determined and proposed corrective actions evaluated. Fourth, there must be a capability of taking action so that deviations of attainment from objectives can be reduced."⁹

The third condition corresponds to 'forward-looking control system concept of Buchele, where he believes in this way the control system becomes a constructive process with the aim of helping managers to carry out plans successfully. The last condition is in line with Anthony, Dearden, and Bedford's factor of span of managers' responsibility and authority. In fact one cannot separate the two theories, but it is the combination of both 'points to be considered by Anthony, Dearden' and 'conditions before any system can be said to be controlled by Emmanuel and Otley' that should determine the control systems implemented in an organization. Managers in carrying out their functions should always pay special attention to motivational aspects of their actions. So is the case with control process.

The control process not only has to check for deviations from plans and possible needs for change in plans, but also it has to be encouraging and let the employee know that achievements are recognized and rewarded. Distinction between the performance of a manager and the performance of his unit by the controller is one way of assuring the manager that his efforts are taken into consideration. Another area that interwovens people and the control system of the organization is the consideration of who is being controlled? and who is carrying out the control function?

The control process and objective in each level of the organization is different. The chief executive is not interested in daily activities and minor deviances. His control function covers managers of the organization. He is mainly interested in the achievement of objectives and long range plans. What they want to know is that, in a so rapidly changing external environment, do their organizational objectives correspond to new developments? They are interested in the execution of long range plans on schedule and also they want to know whether current operations are being kept healthy by subordinates.¹⁰

Normally the control systems in general and management control system in specific should be modified as the organization expands and the needs of the organization change. A management control system that tries in every conceivable manner to check daily operations of a responsibility center or subsidiary is certainly very discouraging to the relevant manager. It carries only one

message and that the top management does not trust him to carry on with his duties, and is in direct contrast with the logic behind establishing responsibility centers.

Management control system usually takes the form of financial and accounting reports. Hartly states that "budgetary control is the area in which financial planning and control of operations are brought together."¹¹ Yet he believes that advantages of a budgetary control are not always gained since all systems are administered by people, and it remains to be seen how the budgetary control is administered. Therefore he emphasizes a participative role by managers in developing their units' budget. Since managers are held responsible for attainment of their budgets, their participation in developing the budgets, gives them a sense of commitment to achievement of budgets. It also makes sure that any item in the budget is in control of the manager in charge. Budgets should also be flexible to allow for unforeseen events.

The amount of pressure imposed through a control system should be fine tuned. Early management theories emphasized tight control and close supervision. Behavioral research suggests that some level of pressure is needed to motivate people. But if it is too much it becomes dysfunctional. Copland and Dascher wrote "control has at least three major effects on managerial accounting communication net work . First, most people behave differently if they know their performance will be evaluated.

Second, analyzing past performance may indicate ways of obtaining superior performance in future. Finally, explaining deviations from expected behavior might clarify the need to modify future planning procedures to represent better the relationships among production variables."¹²

I personally believe that in a management control system sometimes it is permissible to deviate from same common treatment for each and every manger. The control system should to a certain degree consider the characteristics and personality of the manger in question. It should go back to the starting point. Some managers are risk takers some are not. Some managers are better able to cope with sudden external changes. And some managers are to be checked to prevent them from possible misuses of organizational resources .

The focal point of a control system is also very important in the actions taken by managers. A management control system that looks only for the current cost or profit level allows and pressures managers to manipulate data or engage in actions that for the short run will have a positive effect on their budget reports, but are not in the best interest of the long range plans of the organization.

Here the reward system has a profound effect on the management actions. If rewards are closely correlated with current budget performance, it will be just another reason for taking sub optimal actions .

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2.2-Responsibility Centers and Accounting

The formation of responsibility centers in an organization is another control system used to make the control of expanded organization to some degree easier. Responsibility center is analogous to responsibility accounting. In this type of control system the whole organization is divided into subunits with a responsible manager. The divisionalization could be functional (marketing department, finance department, production department, and etc.), regional or by product lines.

The degree of responsibility and authority delegated down to these sub units differs. This difference in the amount of authority determines whether the center is a cost center, revenue center, profit center or investment center. Theoretically the latter has the highest freedom and authority and this freedom decreases as we move backward toward cost center.

In a cost center the manager is mainly responsible for the cost of its center and his authority covers the expenses of the center. For him the cost budget is the main frame of reference. Production units are usually treated as cost centers.

In a revenue center it is the output that is measured in monetary terms. The main responsibility of the manager is to generate revenue. Marketing and sales departments are good examples as revenue centers. A profit center manager is responsible for the profit of the unit. That is, he is responsible for the difference

between the expenses and revenues of the center. Usually the distinction between a revenue center and a cost center is very thin, as it is meaningless to give authority for generating revenues regardless of the costs. There are instances that the revenue is increased say by 20% as a result of an action, but the costs have increased by greater percentage. Therefore it is usually advisable to keep a manager responsible for the profit rather than revenue .

In an investment center the manager has the authority to make capital investments as well. Here the profit is measured against assets that have been used to generate that profit.

"Financial control systems as a tool for management control should be divided to two parts. Financial controls for projects and Financial controls for departments which we know as responsibility center."¹ This is responsibility accounting which must be built on responsibility structure of the organization. Responsibility accounting is based on four principles :

- 1- Objectives : The main objective of the organizations should be broken down into objectives for each one of its constituent parts. These objectives could be stated as the level of cost, profit or contribution margin depending on the type of responsibility center on hand and the accounting techniques established .

Any way, the idea of responsibility center is to select a manager that is professional in the activity carried out by the unit. This in itself makes daily inspection meaningless where the sub units' manager probably has more knowledge regarding what is going on and what he should do than his superior.

The issue is to what extent the responsibility center manager should be given autonomy? This matter is more serious when the responsibility center is a sub-division of the company. Some such as Solomon and Amey believe that in that case the management should not be given investment authority.³ Which is the same as saying that the subsidiary should be a profit center. It will not be allowed to do major investments, nor will the manager be able to raise capital fund. The cash generated will be collected by the central authority to determine the use of it in other areas. In such systems centralized purchasing department is common. The responsibility accounting system is usually the most formal communication system within overall system for management control. As stated by Lounderback and Dominiak, "responsibility accounting is the name given to that aspect of the overall management control system that deals with the reporting of information to facilitate control of operations and evaluation of performance."⁴

This brings us to the issue of evaluating the centers' performance. Though this will be looked into in more specific

terms when dealing with profit centers, yet some general comments are warranted at this point .

As mentioned earlier responsibility accounting is one of the most formal reporting systems and it should be so, because in effect it is reporting the operations and performance of business units that to some extent have been left alone to decide about the way they are going to run operations. Therefore, the top management needs a reliable and accurate report to consider whether everything is going according to the plans. Here it is very important that the evaluator be able to distinguish between the center's performance and the performance of its manager. Although the two are closely connected there are times that combining them together would cause evaluation mistakes. All the old literature emphasizes the concept of controllability when evaluating the performance of a responsibility center manager . The idea is that his performance should be evaluated only based on the elements of operations which he had control over and could have affected. The motivational element of such an act has been stressed, where it is assumed (by a very high probability) that the reaction of the manager being evaluated will be positive and he will be motivated to do his best to control those elements that he can, in a better way. The responsibility account report prepared by the center provides the top management with a continuous flow of information regarding the performance of the center and factors affecting it. One of these factors being the management effort. The participative role of the center's management

in developing the budgets and plans against which his and his center's performance will be evaluated has been emphasized to a great degree. This will help the manager to internalize the objectives of the firm and work in the best interest of the organization which in return is in his best interest as well as his center's. The objectives are said having to be challenging but not unattainable which will have negative motivational effects. Most authors believe that a 50% chance of attainability is a good level.

However, it seems that the more recent literatures are slowly drifting from the old beliefs. Nandan choudhury is one of these authors. In his article "Responsibility Accounting and Controllability"⁵ he states that the initial endowments have been largely neglected in existing literature. According to him a manger normally starts at a position which is unjust in terms of initial allocations of responsibilities and profit opportunities. In such situations responsibility accounting does not automatically rectify the problems. Therefore the "Just" concept of the controllability criterion renders no benefits.

Choudhury deals with this topic from different aspects. One as mentioned above is the unjust initial starting position. The other aspect that he looks into is the manager's perception of controllability and of the rewards. He specifies the controllability as the "ability of the manager to anticipate behavior-outcome-reward contingencies."⁶ Then elaborating

furthermore he specifies that the definition includes :

- 1- Environmental or objective uncertainty which affects outcomes.
- 2- Role conflict and task ambiguity where the manager perceives his function, span of responsibility or the reward scheme to be inadequately specified. It includes the manager's own perception of external and internal uncertainties.
- 3- The manager's influence over the reward scheme .

The last point is an extension of controllability criterion. It points also to the fact that the management's perception of control of outcome is important. Choudhury believes that the manager first tries to influence the reward system, then if he fails he will try to influence the outcome. The 'minimax hypothesis' of Miller suggests "that an individual desires control over possible adverse events because he can act so as to set a guaranteed upper limit on how bad the outcome can be."⁷ For example a manager that has authority to buy equipment internationally will feel less threatened by domestic inflation .

The hypothesis also established that individuals who believe somebody else can effect and set the limit on the worst possible outcome, does not value control much. A manager may value control less if he felt he could depend on his superior to protect him. And I believe this will set the situation for careless use of control and authority .Figure(1) summerizes Choudhury's theory.

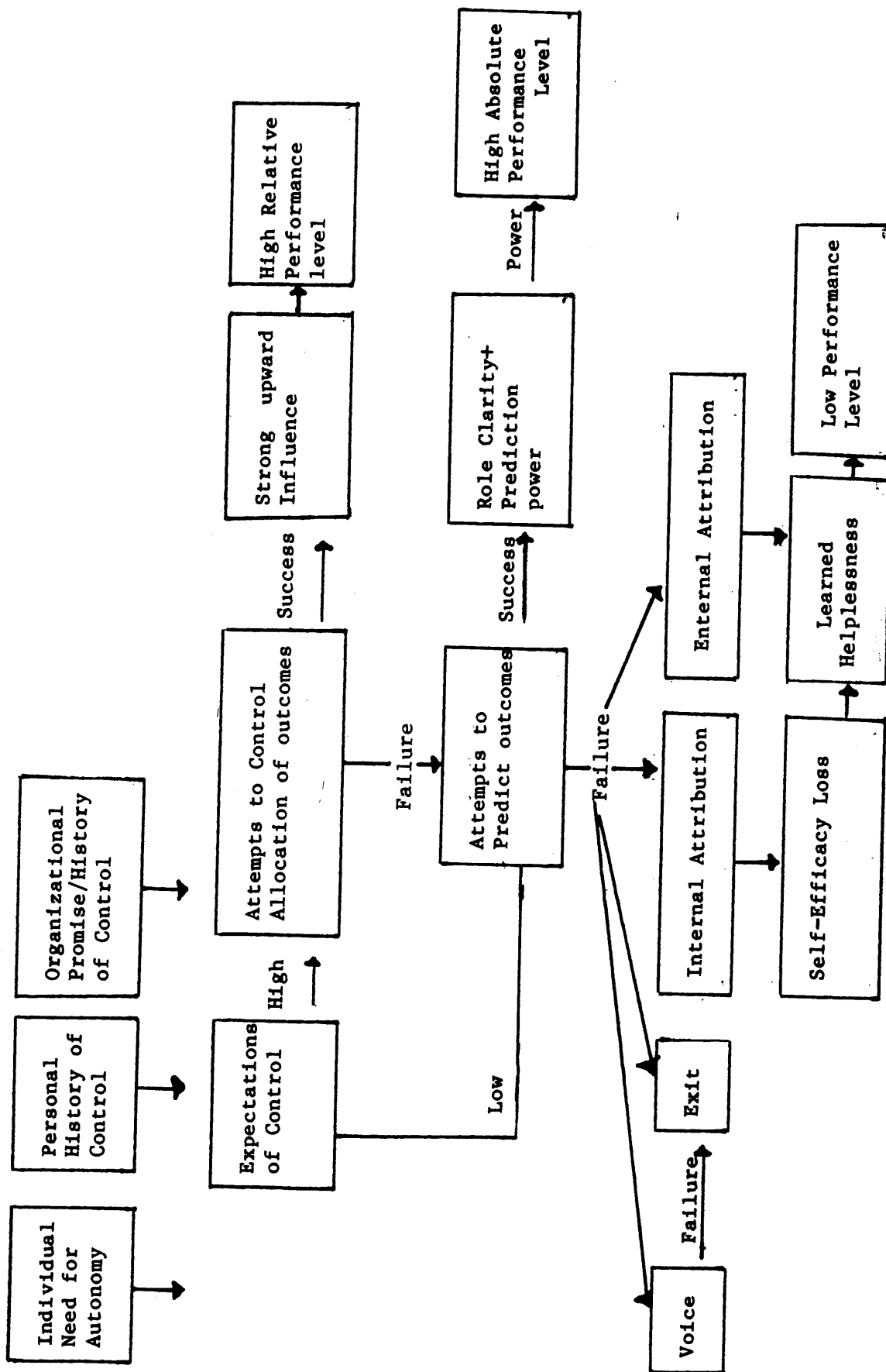


Figure (1): Expectation of Control and Level of Performance

In the last stage internal attribution refers to the fact that other managers are doing successfully, and external attribution refers to the fact that other managers are doing bad as well.

Choudhury says that the organization by no means should immunize the individual against the conditions of helplessness which when internally attributed reduces the manager's ability to learn non-elementary cause-effect relationships and to use initiative and innovativeness. But the organization should help the manager to distinguish between controllable and noncontrollable aspects of his job.⁸ Failure to do so could have serious results such as job burnout where the individual experiences self-efficacy loss, tieredness, without enough energy to carry on and self criticism to a high degree.

Usually performance of a manager is compared with those of his peers within the company or across the industry. This in itself is a violation of controllability concept, because the particular manager under evaluation has no control over the performance of his peers within the firm let alone those in the same position in other firms. Yet this continues to be the norm because it carries valuable information contents regarding the manager's effort. My personal view is that this relative evaluation could be useful if done carefully. I do not believe a cross company comparison is a good act, due to different levels of opportunities, risks, and authorities that the heads of different centers face. It could be more informative if the performance of

the manager is compared with those in the firms that face relatively the same risk and opportunities as the firm doing the evaluation. In total Choudhury suggests that "if responsibility accounting is to serve its intended purpose it should not be constrained by controllability."⁹

An advantage of using relative performance evaluation is that it adjusts the manager's reward to changes in the economic environment. As Patton puts it, "it has been recognized that a key weakness in the fixed formula incentive plans is that they do not reflect competitive performance within the industry. Thus when a company's net income rises 15%, formula based bonus payments are likely to be sharply increased-even if industry profits have jumped 25%. In other words, executives might be rewarded when they actually should be penalized for having lost ground to competition ."¹⁰ It should be noted that formula-based rewards are normally based upon the controllable factors of the job .

However, attempts at improving manager's performance may prove fruitless depending on the level of his organizational commitments. If he has strongly internalized the organizational goals and is ready to work toward achieving them, positive results could be seen. But if he values personal relationships with his peers and belongs to a cohesive group, top executive may face a situation where the center's manager does not try as hard as he could in the fear that he might seem working too hard and be

viewed as imposing negative externality on his colleagues.

Choudhury concludes that "the responsibility accounting concept needs, in some situations, to be interpreted and applied independently of controllability. This situation emphasis is in line with the contingency theory view of the firm which regards the organization structure and information system, of which responsibility accounting is a part, as dependent on the firm's technology, environment and managerial cognition."¹¹

To enable the top management to do a fair performance evaluation that excludes external factors, Choudhury introduces three types of controllability filters: event separation filter, manager separation filter, and period separation filter.¹²

The event separation filter helps to implement the controllability concept by the way of insuring that uncertain external events effecting the center's total performance but out of the manager's control are excluded in the management performance evaluation process. Management information system (MIS) could be set up so that it provides the responsibility center management with pertinent and relevant external information, therefore reducing the uncertainty that the management faces.

The top management of the firm also needs to know about these externalities so that he could do the evaluation properly. External events could have positive or negative effects on the performance level of the center's management. Evaluator needs

to know both. It will also help the top management to prevent the center's manager to take unwarranted actions that are not in the best interest of the total organization but for the short period will increase the performance level of the responsibility center manager. One example is when the risk attitude of the firm differs from those of the center's management. For instance, excluding the effects of currency movement from the foreign subsidiary manager's performance measure, will help the head office to ensure that he does not undertake local hedging which may be sub optimal from the parent company's viewpoint .

Manager separation filter is intended to exclude the effects of interdependencies between managers and a manager and his superior. The aim is to isolate the performance of the manager from the effects of decisions made by other managers. It should be noted that it is the effects of decisions made that are the concern here not autonomy of the manager, which in effect is the decision making. This separation filter covers the long debated area of allocating the head office costs to responsibility centers. It concludes that by no means it should be included in the calculation of net income for the center but should appear as a separate item, unless it can be well established that certain costs of the head quarters were directly linked to the responsibility center in question.

The period separation filter, tries to separate the effects of decisions made by former manager. In other words it tries to

include the future effects of decisions made by the manager in his own performance evaluation. This filter is specifically necessary for responsibility centers that face high level of management turn over. This ensures that managers are held responsible for actions that they do not stay to face the results of .

Individual's perception has great influence upon their performance. Manager's perception of reward system, reward received for a specific action, and his perception of the reward itself are some facets of perception's effect on performance. That is why great care should be taken when evaluating performance of the employees, who in this case is the manager of a responsibility center. It could easily be that there is a lack of communication between the evaluator and the manager regarding their perception of a good job. Task and role ambiguity can hinder the performance of a manager to a great deal, therefore, it is desirable that these areas be cleared before the evaluation process.

To sum up, the responsibility accounting is a reporting system that keeps the top man informed regarding the performance of different responsibility centers and their managers. While evaluating the manager's performance the evaluator should be aware of :

- 1- the controllable and non controllable elements of the job,

- 2- group dynamics and interdependencies between managers,
- 3- the fact that controllability criterion could and should sometimes be disregarded,
- 4- the fact that there is a difference between the performance of a responsibility center and that of its managers .

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2.3-PROFIT CENTERS

Profit centers are one form of responsibility centers, established to allow more effective delegation of responsibilities and authorities in the organization. By definition, a profit center is a responsibility center that is responsible for its costs as well as revenues, and it is the difference between these two that determines the performance of the center. Companies marketing a variety of products and services are mostly divisionalized as profit centers.

In an article in Journal of 'Market Facts', ways of establishing profit centers have been identified as follow :

- 1- Functional profit centers, where the profit center is responsible for any one of organization's activities such as marketing, manufacturing, product development, etc.
- 2- Product profit centers represent a family of product with similar characteristics and the center is responsible for the product from design to development, manufacturing and marketing.
- 3- Client profit centers concentrate on particular markets.
- 4- Geographic profit centers target a specific region or country¹.

In the case of functional profit centers transfer pricing is a major issue that has to be dealt with before a meaningful profit center can be achieved.

Anthony, Dearden, and Bedford provide the most comprehensive literature regarding profit centers and transfer pricing in their book entitled 'Management Control Systems', which I have used extensively in this project.

In 'Management Control Systems',² we read that before responsibilities and authorities are delegated down the line, top management has to make sure that the center's manager is provided with enough and relevant information. This is to enhance the process of decision making. One important reason for establishing profit centers is to allow decisions to be made closer to the information source. As Companies grow in size it becomes very difficult, if not impossible, for the man at top to know all aspects of his organization. Further more, expansion of organization means more specialization and one person can not be specialized in all areas. Also there is a cost saving logic behind divisionalization. Information gathering, analyzing and communicating is a very costly process, and during this process information filters may change the content of the information so that when it reaches top, it does not serve the purpose initially intended.

This data filtering could happen for different reasons. For one thing, employees normally try to hide bad news as long as possible, and magnify the good ones. Secondly, in an attempt to summarize information for management review, some important informative pieces of news might be lost. Therefore it is more logical to allow divisions make their own decisions based on

established guidelines. The profit center manager like any other manager should be aware of other parts of the organization that can be affected by it or have an effect on it, as well as the relevant external environment, to be able to make good decisions.

In sum, profit center set ups should be helped by proper communication system that provides managers with pertinent, relevant and timely data. This system will help top management to check on efficiency and effectiveness of the center's manager as well.³

"When should a responsibility center be arranged as a profit center? "is a crucial question. Most authors believe that a profit center can only be effective when authorities and responsibilities for costs and revenues could be safely and efficiently delegated. In cases that departmental interdependency are high, divisionalization and subsequent profit center formation, may not be the optimal solution. So is the case when centralizing activities will lead to economies of scale, hence, reduced costs and higher effectiveness of decisions made. To this regard, organizations that are functionally divisionalized are less effective in establishing true profit centers. For one thing, most of these profit centers will be 'artificial profit centers',⁴ that their outputs primarily will be transferred within the firm.

This, to a large degree, diminishes the controllability factor for the manager, since he has none or very low control over activities in other divisions. If each division is allowed to deal with outsiders, the supposed savings from producing goods

and services internally will be diminished. Imagine a case where the purchased materials are to be sent to the processing ground as soon as they enter the factory. The purchasing division, in order to benefit from reduced costs and savings in bulk purchases, buys certain materials in very large quantities that can not be processed and used very fast. This act will increase the inventory cost of manufacturing division beyond the optimal point, and might increase their insurance coverage costs as well.

The second question is the "extent of the autonomy to be given to profit centers?" The answer to this question is the same as the one given regarding responsibility centers, since a profit center is a responsibility center. The quality of management, the nature of work, the tendency of the unit to deviate from acceptable lines, the philosophy of top management regarding the delegation of authority, and the level of integration and interdependency among organization's different units will all determine the level of autonomy given to a profit center.

2.3.1-Measuring the Performance of a Profit Center

Profit centers are like small businesses with their own financial reports and income statements. Normally the performance of any unit or department is measured against some standards or costs budgets reflecting expectations from the unit in terms of monetary performance. So is the case with profit centers. A profit plan is established, and the performance of the center is measured

against this profit plan later on. At least this is the way in organizations that try to be more logical regarding economic performance evaluation of their profit centers. For sound profit planning and control we need a responsibility accounting system, in which only relevant elements are considered.

Welch identifies six principal problems in profit planning and control :

- " 1- Developing management sophistication in its application
- 2- Developing a realistic budget
- 3- Developing realistic objectives and standards
- 4- Adequate communication of attitudes, policies, and guidelines by higher levels of management .
- 5- Attaining managerial flexibility in application of the system .
- 6- Updating the system to harmonize with the changing environment within which the management operates.⁵"

The involvement of the profit center manager in developing the profit plan is perhaps the most important step in the process. This involvement will bring management's commitment, and is also a step toward more realistic objectives and budgets .

Efforts on the part of top management and the profit center management are both required to keep an open communication line and a flexible system. This flexibility refers to the system itself as well as the management .

Take frequently emphasized concept of controllability as an example : A certain element which was considered controllable during the period that the profit plan was established, might be proven to be out of the control of the unit's manger, due to later changes in internal or external environment. Such situations call for special attention on the part of the evaluator.

However, as mentioned before, the concept of controllability has been debated by Choudhury, stating that sometimes it is advisable to ignore controllability concept entirely.

It should always be kept in mind that profit plans, or any other budget for that matter, are based on the estimations of what we think might happen in future. We could overestimate or underestimate the events. Moreover, it should be remembered that the development of profit plan does not bring execution of plan by itself, nor it is an end in itself. It is only the beginning of a period of hard work executing the plans and trying to achieve targets as best as one could .

Some advantages of profit planning and control at corporate level are as follow :

- " 1- It forces early consideration of basic policies
- 2- It requires adequate and sound organizational structure
- 3- It compels all members of management from top to down to participate in the establishment of goals and plans.

- 4- It compels departmental managers to make plans in harmony with the plans of other departments and of the entire firm.
- 5- It requires that the management put down in figures what is necessary for satisfactory performance .
- 6- It requires adequate and appropriate historical accounting data .
- 7- It forces management toward efficiency.
- 8- It reduces cost by increasing the span of control since fewer supervisions are needed .
- 9- It frees the top executive from day-to-day internal problems and at the same time provides the lower management with a guideline for decision making."⁶

The same advantages with some modifications can be traced back to establishing a profit plan for a profit center .

Profit is usually considered a good measure of effectiveness as well as efficiency. Yet this yard- stick has its own defects. First of all, too much emphasis on profits, especially on short term profits, pushes the management toward actions that will have positive effects on the profit of the center in the short run, but their effect on the total organization performance or for the long term may not be optimal. Besides profits do not exactly measure all aspects of business activities .

In the book 'Accounting for Management Control' the following potential defects of accounting performance measures are identified :

" 1- Completeness

- a- Corporate and divisional goals can only be selected in those areas where quantitative, financial performance information is available .
- b- The control mechanism stresses short-term performance measurement which may not reflect the long-term trend .
- c- The performance measure is a surrogate and disguises the variability and interdependence of component parts.

2- Accuracy

- a- The targeted performance measure is set in an unfair manner and does not reflect a reasonably attainable standard .
- b- The comparison of targeted and actual performance provides variances that can be interpreted ambiguously.
- c- The valuation rules based on GAAP are inappropriate for internal control purposes .

3- Neutrality

- a- The performance measure does not reflect managerial effort, only results .
- b- The performance measure is effected by interdependency and decisions taken elsewhere in the company .
- c- The rigid style of evaluation, concentrating on the

accounting performance measure, causes opportunistic behavior." ⁷

It is obvious how much these defects are applicable to a profit center, where its performance is measured solely against the profit plan of the center. We can see how the three filters (management-even-period) introduced by Choudhury are useful in making a better performance evaluation, overcoming these defects to a large degree.

"In Vancil's (1979) survey, over a third of the profit center managers recognized profit performance measures as incomplete and certainly not all inclusive reflections of long-term potentials."⁸

One answer to the problem of emphasizing short-term profits is the Hopwood's 'profit - conscious' style, which advocates using budgetary information in a careful and flexible way, with the manager's ability to improve the effectiveness of the division being assessed by the trend of performance overtime. This may avoid some of the worst effects of short term performance evaluation and result in less manipulations in accounting reports, yet accounting information still remains the prime means of evaluation.⁹

One issue determining the performance of a profit center and the level of control imposed from the top management upon profit generating activities, is the level of authority guaranteed to

the unit's management. There are times that an organization is divisionalized into appropriate cost, investment or profit centers, yet, in one way or another, their activities are dictated to them and the level of authority given to a profit or investment center manager is as low as those of a cost center manager or even the departmental manager of a centralized organization.

Here we face an untrue profit center or 'Pseudo' profit or investment center. At these organizations, though the top management knows the advantages and the necessity of a decentralization, but he believes profit making and capital investment activities are too important to be left to the center's management. However, a profit center can never enjoy absolute authority. The degree of authority usually expands as the profit center moves out of the organization's premises, where it was a department; to be a subdivision and from there to be a foreign subsidiary.

In fact it is the distance that commands higher level of authority to be delegated in order to reduce control costs .

Anthony, Dearden, and Bedford introduce two general types of constraints imposed on the divisional management :

"a- Constraints from other divisions

b- Constraints from corporate management divided into

- 1- those resulting from strategic considerations,
particularly financing decisions
- 2- those resulting from the need for uniformity

3- those resulting from the economies of centralization."¹⁰

An example of financial constraints could be regarding capital investments otherwise the center would be an investment center.

Establishing profit centers is a strategic move on behalf of the organization in order to be able to control the organization better as well as introducing more flexibility. Without unifying strategies, each profit center will develop different and perhaps contradictory goals and objectives more in line with personal goals of its manager rather than those of the organization. An organization can not afford its divisions act according to their own rules and regulations. There is need for some general universal rules that pulls separate division to each other. For example a general reporting format should be utilized to make understanding and comparison easier by the headquarters. Conformity to the corporate accounting rule is another example.

There are times that an organization could benefit from centralized services. For example if the company is pursuing a marketing strategy that puts the emphasis on the total organization image rather than the product itself or the division, then it will be more effective and cost efficient to have a centralized marketing unit .

"Ezzamel and Hilton (1980) investigated the degree of autonomy allowed divisional managers in 129 large UK companies, and found

that only limited discretion was granted in determining the methods of budgetary control and internal audit procedures. Close supervision by top management in choosing capital projects and specifying capital expenditures in the annual budgets was observed. However, divisional managers enjoyed substantial discretion in taking operating decisions relating to output, selling prices, setting credit terms, advertisements and purchasing policies."¹¹

2.3.2-Methods of Measuring the Profit

In 'Management Control Systems' the following four methods of calculating divisional profitability are mentioned¹² :

- 1- Contribution margin: The aim is to measure the contribution of the profit center toward covering the fixed expenses. It is assumed that fixed costs are not controllable by the center's management, but in fact these fixed costs most of the times are at least partially controllable. Variable costing is the other name given to this method of calculating profit since it concentrates on the gap between variable costs and revenue. Some argue that even the fixed costs can be influenced by the management. Perhaps not as a direct results of the center's level of activity, but to a differing degree. A good example given by the authors of the book is insurance. Normally insurance coverage is initiat-

ed by the head quarters. However, the profit center manager could take actions to effect the insurance costs of his center. For example by reducing the amount of insured property like inventory and fixed assets, or by reducing fire or safety hazards¹³. Of course in case of reducing the level of insurable property a trade off should always be present. In order to reduce insurance costs it is not advisable to have zero level inventories unless the organization, and the division is run on the basis of 'Just in Time' (JIT) concept developed by Japanese. In this system the source of material and distribution channel are relied upon to provide the needed material just as it is required and there is no need for inventorying the material for later usage. Here the contribution margin is calculated by deducting controllable costs only from the revenue.

- 2- Direct divisional profit: Here the contribution of the profit center in covering general overhead costs and profit of the corporation is used as a measurement of the profit performance of the center. The controllability concept is disregarded and all expenses incurred by the division or directly connected to the division are included in calculations. However, it includes some headquarter's expenses that have been incurred on behalf of the division, and that is its major pitfall. Perhaps this is an attempt to overcome the problem of common costs. For example in some organizations, staffing is a centralized activity which all

units benefit from. The direct costs of hiring the employees for the division might be included but the salary of the staffing department employees and overhead are not included since it is difficult to find out how much of their time or overhead costs was in direct connection with employing staff for that division .

3- Controllable divisional profit: In this method headquarters expenses are divided into controllable and noncontrollable. The profit center's profit is calculated by deducting the controllable portion of headquarters expenses.

4- Income before taxes: Here, all pre tax expenses are allocated to some division. Each division benefits from and uses the services and activities that are carried on in headquarters. Therefore a portion of these expenses are allocated to the division. There could be different methods of allocation. When possible, allocation on the bases of actual use is the best. For example a division asks for maintenance people of headquarters to fix a machinery. Therefore the division should pay for this services, specially that to a great degree this is a controllable cost. The way machinery are handled will determine the frequency of maintenance. If this method is not possible then some arbitrary allocation method could be used .

5- Net income : In normal situations a domestic subsidiary of the organization does not report on the net income after tax

basis. Two reasons are that important decisions regarding income tax are made in headquarters therefore they should not affect the profit performance of the division; and, income after tax is a constant percentage of income before tax, therefore no evident benefit will be gained by calculating net income for the division. However, the situation differs for a foreign subsidiary that have different effective tax rates .

The problem of common costs and common revenues are ever present in calculating the economic performance of profit centers. For example when an organization is functionally divisionalized where the product design, development and marketing takes place in different profit centers, it is very difficult to calculate the share of each division from the revenue of selling the product. General administrative costs of headquarters are examples of common costs. The mentioned methods of calculating the profit center's economic performance, each deals with this issue in a different manner. Other types of common costs involve transfer pricing that will be discussed in next section .

In 'Management Control Systems', four techniques mentioned earlier are labeled as 'Types of Profitability Measures'.¹⁴ In fact these methods do not show the profitability level of the division, but the absolute amount of the profit. Profit center A might have a net income of BD 100,000. What does that mean? Is the level of profit made high enough to justify the investment

different styles each leading to different figures. The combination of all is differing ROI depending on definitions used. For example invested capital could mean only capital locked in inventories. Or it could include some major capital investments on behalf of the total firm from which the division is supposed to benefit as well, therefore has to account for at least part of the investment. It could be the addition of inventories and other direct investments in the division.

This flexibility in defining the formula allows a fair cross organizational comparability. However, if the division is to be compared with industry levels, income and invested capital should be derived at in the same way as of the industry. It is relatively easy to do both ROI calculations for both purposes. It might bring a problem with it however. How is a profit center to be ranked when its performance compared to other organizational divisions give different results than when compared with industry? ROI calculation can be broken down into the following formulas :

$$\begin{aligned} & (\text{Income} / \text{Revenue}) \times (\text{Revenue} / \text{Invested Capital}) \\ & = \text{Income percentage of revenue} \times \text{Capital turnover} \end{aligned}$$

Improvements in ROI can be established by two means :

- 1- Increase income percentage by reducing expenses
- 2- Increase turnover by decreasing investments in inventories¹⁵ .The first way is relatively easy. A manager under pressure to improve his divisions' return on investment ratio in a short period could cut down expenses such as research and

development, advertising, adequate maintenance, quality control, customer relation and employee morale. The impact is almost immediate and noticeable, but the question is whether this is in the long term interest of the organization, or division for that matter? That is, why it has always been warned that a mere high figure of ROI ratio does not explain everything but it should be looked into in conjunction with other data. Management should be alert to seek out the reasons for sudden high improvements as well as the decline in the ratio .

In the second way of improving ROI, investment in inventories means investments in cash, receivables and inventories¹⁶. There is always an optimal level for these items which the division should try to achieve. Too little inventory may hurt sales and too high level of each item is wasteful and inefficient. Those companies that prefer an absolute amount of income instead of a ratio for measuring profitability, could use residual income (RI) calculations. The following example helps us understand the way RI is calculated. Suppose the average invested capital in division A for the year was BD 1 million. The corporate headquarters assesses an 'imputed' interest charge of six percent, ($0.06 \times \text{BD } 1,000,000 = \text{BD } 60,000$). Imputed interest charge means that the charge is made regardless of whether the corporation as a whole has actually incurred an interest cost in the ordinary sense of a cash disbursement. The rate represents the minimum acceptable rate of return on investment in that division.

Assuming a divisional net income after tax of BD 80,000, we drive at RI of BD 20,000.

Division net income after tax	BD 80,000
Minus impute interest on average invested capital	60,000
Residual income	<u>BD 20,000</u>

The ROI of the division will be eight percent .

When ROI is used for profitability calculation, a division that currently has a 12 percent ROI will be reluctant to accept projects and investments that have ten percent return, because that would dilute the present ROI ratio. However, from the head quarters point of view a ten percent return might be quite acceptable. Even if the head quarters specify the minimum level of return acceptable, most divisions try to stay at much higher end of the spectrum, ignoring the higher risks associated with the higher return on the investment. Therefore, these organizations would usually be at high risk positions. Also, for the organization itself this preference on the part of profit center management means loss of projects that otherwise could increase total organizational profits."Residual income is favored for reasons of goal congruence and managerial effort.¹⁷" It forces management to accept projects that increase profit even if moderately. In an article by Walter Schertler¹⁸; which concentrates on profit center concept as well as the profitability issue; we read about Ansoff's 'organizational responsiveness', by which he means the quality and types of behavior made possible by the

capabilities of the firm¹⁹. The organizational responsiveness is categorized into five areas ."

- 1- Operating responsiveness: The goal is to minimize costs of the firm's products. Efficient production through standardization and specialization of work create economies of scale which are the key factors to help to achieve this goal. The firm keeps overhead costs and investments in marketing, R&D, or management on the lowest level as possible.
- 2- Competitive responsiveness: Tries to maximize the firm's near term profitability of fostering cooperation between production and marketing. Concentration is focused on the maximal market penetration and benefits from experience curves. To achieve optimal profitability the decisions are decentralized. Profit center management becomes a very widespread management concept. Operating and competitive responsiveness seek to assure the profitability of the firm's present products and markets .
- 3- Innovation responsiveness: Is product oriented and tries to optimize the near-term potential of profitability by new product and market development. R&D is one of the most important functions and investment centers. The time perspective of management focuses on the near-term future of the firm by anticipating new technology/design or need trends.

4- Entrepreneurial responsiveness: Seeks the firm's long term profitability by balancing the product/market portfolio. Strategies are focused on the creation and development of potential technologies and market needs. General management concentrates attention, creativity and resources to support the long term viability of the firm .

5- Administrative responsiveness: Means all the capabilities which support the other kinds of responsiveness in the sense of management and logistic technologies; i.e. the implementation of an adequate structure, adequate management information systems and adequate design/manufacturing technologies (CAD,CAM).²⁰"

Then Schetler drives at the conclusion that the concept of profit center management only deals with two of the above organizational responsiveness, namely operating and competitive responsiveness and concludes that the concept can not become a contemporary management concept.²¹"

According to him, profit center management concentrates only on : near-term profitability, the products, markets and technologies of today, cost minimization on minimal general management assistance, maximal decentralization, and incentive structure only for low costs and for profitability. He suggests that profit center concept is applicable to markets and industries with slow and constant growth and stable technology²².

I do not find Schertler's line of reasoning acceptable for the following reasons :

- 1- Though he gives the benefit of concentrating on operating responsiveness by the profit center concept, he does it more to discredit the concept as he follows that innovations and R&D are neglected in profit centers. However, throughout this chapter different authors and advocates of profit center concept have been referred to, emphasizing the need for the top management to do a through analysis of the economic performance of the center trying to find out whether the lower costs or higher profits have been due to cut down in R&D, and, if so, take the proper action.
- 2- It has also been established that the top management should not concentrate on short term profits, but should seek out profit plans and projects that enhance the long term profit position of the firm .
- 3- Schertler states that incentives are based on profits. As has been mentioned before and will be discussed later again, from the beginning; Solomon (1965); to the more recent literature; Dearden (1987); the emphasis has been on separating the center's economic performance from that of its management. It has been established that for motivational purposes as well, it is not enough to concentrate on the center's profit in evaluating the performance of the department manager.

- 4- Maximal decentralization mentioned by him does not mean no control and no monitoring system. Ironically, this decentralization is partly aimed at encouraging innovative behaviors, that he finds lacking in profit center concept. In profit centers the communication channels are shorter and more informal, and as people are specialized in the area of their work it is more likely that innovations and breakthroughs either in production technology or products and markets be witnessed .
- 5- My final comment is that pitfalls mentioned by Walter Shertler are not inherent in profit center concept itself. Rather, they are the practices of the practitioners that lead to these conclusions. This concept is a tool, or a machine, it rests upon the user to find the best way using and benefiting from it. An alert manager can benefit to the highest degree from this concept. Profit centers, if established and managed properly, are the "strategic center management"²³ which are based on 'strategic business units' that Shertler advocates. Choudhury's three management filters when used properly in profit centers make them very useful.

2.3.3-Management Performance Evaluation in Profit Centers

Performance evaluation process has always been considered one of the most important management functions as a motivating tool. The manager of a profit center is not different from his colleagues in this respect. Performance evaluation is so important due to its communicative characteristic. It lets the person under question to know how he has been performing or rather, how his superior believes he has been performing, and how his works and achievements are rewarded. At management level the monetary rewards are not that important as cash rewards but for the message that they carry with them. Unfortunately performance evaluation, most of the time, is not used by the top management as a communication channel to tell the employee what is wrong and how he could improve his performance. It is mostly used for punishment purposes and hence gives rise to negative attitude among the employees toward these activities. They are let to believe that their activities are being scrutinized by superiors only to fix the blame, and nobody cares why things did not turn up as plans and budgets.

A wrong management performance evaluation format in a profit center would emphasize only profits with the performance of the management being evaluated directly against economic performance of the center. Manager's performance is evaluated against profit plans that he had no participation in developing them and exter-

nal events and changes are ignored. In short it is myopic and inflexible .

As mentioned before though ROI and its modification, RI, are the most favored profitability measures, yet their sole use as profit measures is being questioned and it was established that these two yard sticks could give misleading results. This increases potential dangers of evaluating manager's performance by ROI. Even if ROI was the best profitability measure, still it would have been unfair to directly relate the performance of a manager and its center through ROI. There are times that external events make a forecasted ROI irrelevant. The situation is more acute when the actual ROI is lower than expected. Yet this lower ROI might be worth being rewarded, given the circumstances. How manager's performance is evaluated has direct bearing on the way he behaves. In an article by John Dearden²⁴, managers are advised to understand what is wrong with the system before trying to correct it . He points out that there are conceptual errors in profit center measurement systems used by managers other than using ROI :

- "1- The failure to distinguish between techniques used to measure past financial performance and those required to establish future performance objectives .
- 2- The failure to differentiate between systems that measure the performance of the profit center and those that measure the performance of its managers.

- 3- The failure to segment variances from the budget by differences in the way that managers can influence them.²⁵

He advocates that conventional accounting system should be used for profit center financial statements and separate profit budget reports to measure managers²⁶.

Variances from the budget should be judged against managers explanation. And managers should be held responsible for those items in the profit plan that they can control and influence. The reporting system accompanying this budgeting system is divided into three parts by Dearden:

- 1- an analysis of variances from budget,
- 2- an explanation of the causes of those variances and any corrective action being taken,
- 3- a forecast for the year .

He finds that many managers are confused over differences between a budget and a forecast. A budget as he explains is a plan based on assumption that certain steps will be taken to make things happen as planned. On the other hand a forecast is a prediction of what will most likely happen, but it does not mean that the forecaster will try to influence the events so that they happen as forecasted. A company should separate forecast items in a budget, because the managers are not evaluated on their ability of forecast but on the basis of their managerial capabilities²⁷.

I believe, here, we should try to distinguish between types of events being forecasted. A drastic change in external environment related to climate catastrophes can not be forecasted, but a good manager should be able to predict the customer behavior to some extent. Perhaps this part is covered under his explanation of budgets .

Another factor bearing on managers' performance is the level of achievability of budgets plans. According to the conventional literature, targets should have less than 50 percent chance of achievement to motivate the managers to do their best. However, as pointed out before, this theory is increasingly disregarded these days, and participation of the centers' management in setting the budgets makes achievability more likely and it has been concluded that this is more motivational to managers .

A study by Vancil, established that "annual bonuses were received by 90 percent of managers in the survey, and current financial performance played an important role in determining the annual bonuses. For 2/3 of managers the bonus was calculated by means of a defined formula. From a total of 282 profit center managers, 30 percent believed the bonus was determined solely by financial performance, and 35 percent believed it to be partly determined in this way²⁸ ". From the results of this survey one could conclude, since profit center managers believe that their performance evaluation is related to economic performance of the unit; the correctness of this belief is irrelevant; it is more

motivational for them to work for achieving a budget that chances of its achievement are higher than the chances of failure .

I should remind that the intention of this project is by no means to discredit the use of ROI in measuring profitability of profit centers, nor do I mean that financial performance of a profit center should have no effect upon its management performance evaluation. The aim is to warn managers in the way they use ROI. They should be aware of ROI pitfalls as well as supposed advantages. Insistence on ROI, is insistence on short term profitability and its consequent managerial manipulation. ROI should be supported by other performance measures that aim at long-range profitability. One suggestion is the use of internal rate of return.

Dearden(1987) in an article summarizes the pitfalls of ROI under the heading 'How ROI Can Hurt²⁹', as following:

- The emphasis is on optimizing a ratio, which could discourage growth in the most profitable divisions. Investments in high profit divisions may lower their return, while the same investment in low profit divisions could improve it .
- Investments that might earn satisfactory returns will not do so at first because ROI requires that the investments be increased by total gross book value of the new assets. Managers may not invest if they expect their return to be

short. Also, their returns will increase over time if they do not make new investments.

- All assets in the same division; whether special purpose assets, general purpose assets, or working capital; must earn the same rate of return. More over, this rate of return is often inconsistent with the company's cost of capital .
- The same assets in different divisions may have different implicit interest rates, which may lead to different inventory decision rules in different divisions for identical items of inventory.

Under certain conditions, division managers can increase their rate of return by scrapping perfectly good assets .

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2.4-Transfer Pricing

Transfer pricing settlements are important issues in most organizations today, with most organizations divisionalized into profit or investment centers throughout the world.

Not long ago organizations discovered that if they start producing the intermediary products or even the raw material that they need for their final product, they could benefit from large savings that other wise had to be paid to outsiders. This is true also for inhouse distribution channels and marketing of the product in large scales. In more recent times however, some organizations feel that it is better to leave some of these jobs to specialized organizations that could do it cheaper due to large economies of scale that they benefit from. This in itself has become an issue for consideration within organizations at profit center levels and at top management levels. Should the top management demand from the profit centers to get those good and services available in-house, internally no matter what the cost is ?

In this situation what does happen to the profit performance of the unit and organization as a whole and to the management morale, considering a good portion of his authorities is taken away?

Should the organization allow profit centers to secure what they need any way that they find more profitable, internally or exter-

naly? Then what does happen to in-house producers if the profit center choose to buy from outside sources?

Transfer prices by Charles T. Horngren definition are "The amounts charged by one subunit of an organization for a product or service that it supplies to another subunit of the same organization. Most often, the term is associated with materials, parts, or finished goods. In a most fundamental sense, all cost allocation is a form of transfer pricing."¹ The last sentence includes the charges of service centers which increasingly are becoming important profit centers in organizations.

When the organization is arranged as profit centers, each unit is responsible for its own profits as well as the total organization's profit. This situation at times brings about a dilemma for the profit center management. On one hand he is responsible for making his unit a profitable center and achieve profit plans developed for the center, and his own performance evaluation is largely based on economic performance of the unit. On the other hand, he is responsible for part of organizational profitability. He is not supposed to take actions that will only augment his unit's profit, but also should consider the soundness of his action regarding the organization as a whole.

The existing transfer pricing system within an organization has great effect upon decisions made by profit centers' managers. In some cases the decision making of the manager is reduced by this system, where the top management decides which goods and services

should be sourced internally, and which could be bought externally. Normally, when confidentiality, very high quality, and reliable delivery are important elements of production, then internal sourcing is the only way and that is when transfer prices come into picture. A true profit center to a large degree should be able to decide regarding the source of needed material or the price settlement between the units.

There are four basic techniques for determining the transfer prices of goods and services that can be broken down into measurable units :

1- Cost based - This is a simple method where the buying division is charged only equal to the cost of product or service. No profits for the selling unit is considered.

The system can be dysfunctional in that it does not have a built-in mechanism for telling the manager when transfer should or should not be made between divisions². Another problem with cost-based system is that it does not force the selling division's manager for efficiency. Whatever their cost of production, it will be transferred to the buying division. The accumulated costs of inefficiencies burden the final division that markets the product; reducing its profitability and ROI ratio which normally is used to measure the profitability of the center; for inefficiencies beyond the control of the unit's management.

This system will reduce the opportunities for competitive pricing in a price competitive market, and reduces profits in markets that prices are fixed.

Advocates of this method argue that the standard costs should be used as transfer prices not the actual costs, to avoid the transfer of inefficiencies. I believe that would be a very arbitrary mechanism, where the resulted selling price to the outside market will not reflect the true cost of production, because prices will be based on standard costs. Obviously a cost based transfer pricing system is not suitable for profit centers, because it does not allow the selling unit to add to its costs for profits.

2- Market based - In this method the selling division charges the buying division a transfer price equal to the market price. therefore a prerequisite for reinforcing this method is the existence of an external market with relatively homogeneous prices, upon which the transfer price can be decided. Normally the price charged is lower than the actual market price due to deduction of distribution and marketing expenses that otherwise the selling division had to bear.

This system encourages selling units to increase their efficiency to gain higher profits.

3- Marginal cost based - Advocates of this method argue that the selling price should be equal or higher than the variable cost of

production. This method would understate the profit of selling center and the expenses of buying center. If the buying unit is the last one in the chain and sells to external market, its profits will be overestimated disproportionately. The only time that marginal costs seem reasonable is when the unit is producing at full capacity, but is not able to sell all its product externally. Therefore it is only wise to sell the excess internally at variable cost to reduce the losses.

4- Formula based - At times the organization decides the transfer prices within the organization by using a formula of 'Cost plus certain amount of profit'. Though, this is an attempt to make a cost based transfer pricing system suitable for profit centers, yet it carries all disadvantages of cost based system, pushing the prices even higher and reducing the final divisions profit furthestmost.

Organizational policy regarding the sourcing of materials and services, the existence of external market to buy and sell to, the level of interdepartmental dependencies, and shortage or excess in the industry are some of the factors influencing the transfer pricing method used in organizations. An unreasonable method will lead to sub-optimal decisions, is demotivating and allows manipulation of prices to give a better picture of the units. For example consider a situation where there is shortage in the industry for an intermediary product, therefore the buying division is not able to secure as much as it needs, for the final product. On the other hand another unit of the organization is

producing this intermediary product and selling all to the outside market where the unit's profit is enhanced as compared to internal transfer pricing system based on another method than market based. In this situation the profits of this unit are increased but the final unit's profits are reduced and the total organizational profit is reduced, because normally final products sold to outside markets carry higher profit margins.

Negotiations between involved units is one way of setting the prices, however, negotiations could become lengthy and costly in term of time wasted on negotiations, therefore the final benefit will be less than what was intended. However, this is a frequently used method in cases that a profit center is solely producing a specialized item for internal use. In these situations there is no ready external market for the product and this fact reduces the negotiation power of the selling unit. The cost based method is not reasonable because the center is a profit center. Perhaps in these situations formula based methods such as 'cost plus a profit' are the only way to shorten the negotiation period. However, I believe the selling center's costs should be periodically checked to reduce the chances of high inefficiencies.

What happens when prices in the market change, say it goes down? Should the selling unit reduce its prices? Should the buying unit go to outside sources now that they are cheaper?

Assuming that divisions are free to do their transactions

internally or externally, if the selling division is producing at full capacity and is able to sell all of it externally, then there is no reason why it should reduce its prices for internal use. If there is excess capacity the excess could be sold internally at marginal cost. However, if the production costs of the unit are so that its prices are not competitive in the external market any more, they should negotiate a price with buying unit. Their profits will be reduced, but that will force the unit manager to look for inefficiency points.

The whole thing becomes more complicated when foreign subsidiaries come into the picture. Organizations usually use transfer pricing techniques to avoid taxes or to repatriate profits. The performance evaluation becomes more ambiguous as the foreign subsidiary managers find ways of manipulating profits through transfer prices and exchange rate fluctuations.

In an article by 'Cassel' and 'Cormack' (1987) a dual transfer pricing mechanism is suggested³. The system is to provide the management with the benefits of decentralization but avoid the pitfalls of transfer pricing. It provides interrelated units with relevant cost information for short-run decision making, creates incentives for management by enabling the unit to be operated as profit center, and enables top management to measure the cost of their transfer pricing policy.

In this method the price charged to the buying unit is equal to the cost incurred by the selling unit. The selling unit is

credited at the market price and the difference between two prices is charged to internal sales. This amount must be deducted from total revenue in the process of consolidating the units for the financial report of the organization as a whole.

In this way the duplication of profit centers' profit is avoided and the accounts reflect the real profit generated by selling to outside source. It should be noted that this dual transfer pricing is best for organizations that only transfer intermediary products between the units of the organization. No external sale is made in the intermediary process, only the final product goes into the market. This policy provides the selling unit with an incentive to maximize profit while providing the buying unit with relevant cost information. Conflict between unit managers could be reduced since there is no price distinction made between internal and external sales, therefore there is no need for negotiations. The idea of dual transfer pricing was first introduced by 'Anthony and Dearden' in 'Management Control Systems'.⁴ Then it was adopted by 'Cassel and Cormack' in reference to car dealership business.

The allocation of costs of services that are centralized such as general administrative costs that have no measurable units are other problem area. In 'Management Control Systems' it is suggested that such activities should be divided into three segments: those that are controllable by the profit center manager, that are basically dependent upon the frequency of use; and those

that are not controllable by the profit center manager; such as accounting staff costs; and finally costs that are partially controllable⁵.

As mentioned in 'profit center' section all these costs are in one way or another charged to the centers. These allocations in themselves are transfer prices.

Regarding the uncontrollable services, it is usually advisable that for motivational purposes their costs be charged as separate items after calculating the income of the center, so that the economic performance of the center is not reduced by that amount. However, it is strongly advised that they should be charged; in contrast to controllability concept; in order to force managers to use these services.

In respect to costs of services that profit center managers have to use but the amount of usage depends on them, it is normally believed that a transfer price equal to variable cost of services provided should be charged. However, some believe this transfer price should include a contribution to cover part of the unit's fixed costs as well. The argument is that if the using unit does not find this price attractive enough to use it frequently, then there is something inefficient in the service unit that pushes the variable costs up. If the service providing unit is a profit center itself, then it is most likely that a market price for similar services provided by outside vendors will be charged.

The third situation is when units are free to decide whether they are going to use the services provided internally or not. "In effect, management is delegating the responsibility for supporting these particular central services to the users."⁶ If transfer prices are compatible with outside prices then the service division's services will be used and it will continue its existence. Otherwise there will be pressures for more efficient methods of doing the job.

The specific methods used in each organization has major influence upon the performance of the managers and their unit, the morale of employees and total efficiency and effectiveness of activities carried out in the organization. The following is a good example of undesirable effects of a bad transfer pricing system. 'Bellcore' was formed in 1984 after AT & T was broken up as the centralized organization supporting seven regional holding companies. Lots of transfers were being taken place between Bellcore and its client companies as well as between Bellcore's in house departments. The transfer prices of services such as travel planning, records management and library services, that had no measurement units were lumped into overhead and were allocated to all Bellcore's internal organizations according to head count. Managers found that the charges were too high and they could hire an independent contractor to do the jobs at much lower cost. In 1987, the organization found itself in a situation that most of his employees the majority of which are scientists, engineers, and mathematicians were either doing their

own word processing and graphics or busy hiring outsiders to do the job.

Therefore, these highly specialized and highly paid people were engaged in activities that were not in line with their jobs and confidentiality and security of researches done were jeopardized by hiring outside contractors⁷. The head count allocation base was irrelevant in these situations. A center may be heavily staffed but its employees are mostly clerks and secretaries. These people are not sent to business trips, and they do not use technical libraries. However, they were charged highly because of the number of employees. The allocation was changed to head count of technical and administrative professionals in a department.

END NOTES

- 1- Charles T. Horngren, Introduction To Management Accounting, 6th ed. (U.S.A. : Prentice Hall, Inc., 1984), P. 285.
- 2- Robert N. Anthony; John Dearden; and Norton M. Bedford, Management Control Systems, 6th ed. (Homewood, Ill.: Irwin, Inc., 1989), P. 282.
- 3- Herbert S. Cassel and Vincent F. McCormack, "The Transfer Pricing Dilema and a Dual Pricing Solution," Journal of Accountancy, (September/1987):, 3, PP. 166-175.
- 4- Anthony; Dearden; and Bedford PP. 296-299.
- 5- Anthony; Dearden; and Bedford, PP. 2999.
- 6- Ray H. Garrison, Managerial Accounting, 3rd ed. (U.S.A.: Business Publications, INC., 1982), P. 450.
- 7- Edward J. Korac and Henry P. Troy, "Getting Transfer Prices Right: What Bellcore Did," Harvard Business Review (September/October, 1989): 5, P. 299.

3-EMPIRICAL RESAERCH FINDINGS

3.1-DATA ANALYSIS

The following is my assessment of existing situation in organizations established in Bahrain regarding their management control system in general and the use of profit center concept in specific. The facts presented here are based on information gathered through questionnaires and interviews as specified in 'Sources and Methods of Collecting Data' section.

Interviews were directed mainly toward understanding the calculation of the profit for each profit center; performance evaluation; interdepartmental transfer prices and the motivational aspects of existing management control and reward systems in the organization under study.

The following tables present some information gathered in percentages and numbers. These are the responses of managers at different levels. Here I have included the responses of those that failed to specify their organization's line of business since it has no bearing on the conclusions arrived , at this point. This increases the number of responses from 36 to 41.

**Table (I) The Result of Responses Gathered Through
Questionnaires and Interviews**

	Yes	No	Total	% of Yes	% of No
1- Do you think you have enough authority to control costs and revenues of your center?	22	19	41	52.5	47.5
2- Is your organization centralized?	24	17	41	57.5	42.5
3- Do you find management control system in your organization motivating?	21	20	41	51	49
4- Are centralized costs allocated to the profit centers in your organizations?	31	10	41	75.6	24.4
5- Do the allocated centralized costs appear as separate item in the income statement?	16	15	31	51.6	48.4
6- Is management performance evaluation in your organization solely based on budget achievement?	27	14	41	66	34

**Table (II)- The Results of Cross Analysis Between
Some Questions**

1. Do you think you have enough authority to control costs and revenues of your center?		Do you find management control system in your organization motivating?		No.out of 41	%
YES	NO	YES	NO		
—		—		17	41.5
—			—	6	14.6
	—		—	14	34.1
	—	—		4	9.8
2. Are you rewarded for outperforming the budget?		Do you find management control system in your organization motivating?			
YES	NO	YES	NO		
—		—		14	34.2
—			—	8	19.5
	—	—		7	17.9
	—		—	12	29.2

As can be seen from Table (I) 52.5 percent of respondents felt that they had enough authority to control the revenues and cost of their center and carry out their daily activities. 57.5 percent responded that their organization is a centralized one.

Not all respondents from an organization produced the same response to these question. Later on we will see more specifically from which organizations this contradictory information was gathered.

75.5 percent of managers said that centralized costs were allocated to their departments (31 manager). 51 percent of these (16 out of 31) said that though the centralized costs were allocated to their departments, these costs appeared as a separate item on the income statement of the center. That is, the economic performance of the center was evaluated based on profits before such allocations.

66 percent of the managers said that budget achievement was the only criterion that they were evaluated upon, with special situations taken into consideration . From the remaining 14 respondents, nine said that they were evaluated based on achieving budgets as well as achieving other objectives set for them or by themselves. The other five did not know exactly how their performance was being evaluated.

Table (II) is the result of my attempt to find a relationship between having enough authority and finding the management con-

trol system motivating, as well as relationship between the latter and the reward system in the organization.

41.5 percent of those that found the management control system motivate believed that they had enough authority, whereas only 34.15 percent said that they were happy with management control system and were rewarded for outperforming budgets. And only 9.8 percent of those that thought they did not have enough authority found the management control system motivating.

Table (III) explains the situation in a cross analysis of three questions asked: A- Do you think you have enough authority to control costs and revenues of your center and carry out daily activities? B- Are you rewarded for out performing the budget? C- Do you find management control system in your organization motivating?

51 percent found the management control system in their organization motivating (21 individual). Out of this, 13 persons felt they had enough authority, and they were rewarded for outperforming their budgets. [Refer to Table (III)] . Five of those individuals that found the management control system in their organization motivating, said that they had enough authority, but were not rewarded for outperforming their budgets.

Only two managers said that they found management control system practiced in their organization motivating, even though, they did not think they had enough authority, but were rewarded for out performances.

Table (III) Cross Analysis Between
Three Questions

A		B		C		No.	%
Yes	No	Yes	No	Yes	No	Total	
						41	
—			—		—	2	4.9
—		—			—	1	2.4
	—		—		—	10	24.4
	—	—			—	6	14.6
—		—		—		15	36.6
—			—	—		5	12.2
	—	—		—		2	4.9

six out of 20 individuals that did not believe that the prevailing management control system in their organization was motivating, were rewarded for outperforming the budgets, yet thought they did not have enough authority for their daily activities and controlling revenues and costs of their center.

The derived conclusion is that, as always suspected and proven by various studies; at managerial levels monetary rewards have less

impact and importance as a motivating factor. Its importance is only in its indication of success. For a profit center manager having enough authority to determine profit generated at his center is much more valuable and motivating. Of course, this is not to say that monetary rewards are not important, rather their importance stands in conjuncture with other motivating factors.

As mentioned before only two people stated satisfaction with management control system in their organization while they did not have enough authority but were rewarded for outperforming budgets. On the other hand , if the rewards are in the form of promotions, which normally come after successive outperformances they could be very motivating .

Promotions are valued mostly because of the supposed higher authority that they offer to the position holder not because of higher salaries .In most cases the increase in the salary is not much .

As can be seen none of the respondents mentioned any ratio (ROI or ROA) being used for evaluation purposes. When asked from the interviewees, some said that the ratios were calculated only for their informative nature. Others stated, and correctly so, that the use of such ratios for their organization (service organizations) is not wise and could lead to misleading results since their investments in fixed assets compared to profits made was negligible.

The following section includes data gathered from organizations under study with specific references to such organizations. For this section only 36 of the respondents' answers are included, because these were the ones that could be traced back to specific line of business.

3.1.1-HOTELS

Hotels in general have two profit centers, namely Rooms and Accommodations; and Food and Beverages. These two profit centers in the hotels under study were charged only for their direct expenses. None of them was charged rent for the space available to them and general costs such as general administration costs, electricity, maintenance, personnel, public relations and any other such costs deducted from the total revenue of the hotel in the consolidated income statement. If support departments cost were allocated to each other they were done at actual costs because , as mentioned before only two departments are known as profit centers.

The management style in three hotels understudy differed to a certain degree, but all three showed a somewhat restrict control by the superiors. One of the managers interviewed in Gulf Hotel stated that due to low authorities delegated to him, he had to refer to the general manager too frequently for getting approvals in order to be able to do his job. He said that due to his good relationships with the general manager he had no difficulty in

getting the approvals, yet he understood that not all managers had such close relationships with the general manager.

Obviously this is not a very desirable situation to be in, where one's performance depends heavily on his relationships with his superiors. I do not deny that this situation exists in almost all organizations but the severity of situation differs and that is when the difference in management style becomes evident . Considering the fact that this good relationship was not based on superior performances in the past, as the manager in question was new expatriate.

The same issue of unequal treatment by the top management was brought up by a respondent from Diplomat Hotel.

In Gulf Hotel the budget is prepared by the center's management and the general manager, with the latter having a heavy influence in the process. Then this budget goes to financial controller for approval. Regency Hotel's management seems to practice a more flexible style than the other two. This fact was noted during the interview with Rooms and Accommodation manager as well as the way budgets are developed. The relevant manager, general manager, financial controller, and directorate of sales meet together and decide on the next year's budget. In my opinion, hotels in Bahrain though have attempted to establish profit centers, yet have not been very successful. This is not because they calculate the contribution margin as the profit of the profit centers, rather, it is about the way management delegates his au-

thority. It is obvious that even though profit centers are established but decentralization to an acceptable level has not been achieved. Besides, the wisdom behind calculating contribution margin by these hotels is not controllability concept, rather this is a format that they have adopted without questioning it .

From the accounting point of view there could be arguments for and against not including rent or depreciation of building in driving at profit of the center. Argument for including these charges would be that in that way each manager knows the cost of office he is occupying and his profits should cover the investment made in the building. The counter argument will be for example that is the rooms manager to pay for the space of his office or for all the rooms in the hotel since they are the source of his department's revenue? The rooms manager in Gulf Hotel believes that the level of occupancy of the hotel is not his responsibility, rather this lies with marketing and sales department to get people into the hotel. If that is so then the marketing and sales department in hotels should be arranged as profit centers too to encourage the managers to do an effective job. Of course then a problem of common revenue will be raised which could be solved by different techniques.

When asked why the general administration costs are not allocated to departments, the response was that the whole hotel is seen as one and management is working on behalf of all departments there-

fore there is no logic in allocating the costs of management office. Notice that the reason given is not regarding the controllability or non-controllability aspect of this cost.

In Gulf Hotel, the kitchen uses electricity as well as gas for cooking. Gas is directly charged to food and beverage department. However there is no device to measure the amount of elasticity used in cooking, which is relatively high. Therefore, even though this is a profit center but some costs of its operations are borne by other departments.

Also, the manager of food and beverage department believes that expense part of his department's income statement is not detailed enough and leaves a lot of room for a person in his position for opportunistic actions which are not in the best interest of the hotel.

In respect to management control and performance evaluation in Gulf Hotel, all managers receive a flash report every two weeks stating their current position measured against their monthly budget. The managers feel that this will help them to control their costs or do something regarding the declining revenue before the monthly management report meeting. The budget is used as one important factor in evaluating the manager with consideration regarding any special circumstances affecting deviations from budget. Monetary rewards are received if special high performances are achieved. However, the food and beverage department manager stated that in the year 1989 even though he did

not achieve his budget, he still received a substantial bonus. One wonders whether this was due to an important task done or due to his good relationship with the general manager. He, himself believed that the bonus was more than what he deserved. However, the rooms manager was not very happy regarding the reward system in the organization, which is another indication of unequal treatment by the general manager.

In Regency Continental Hotel managers have more confidence regarding their level of authority and are pleased that they have a chance to explain deviations from the budget even if these deviations are high.

In Diplomat Hotel food and beverage manager and the overall manager (may be that is the title they use for operation manager) felt that their responsibilities and authorities match, and they felt they have enough authority to carry on with their day-to-day activities. On the other hand the rooms manager though agreeing on the match between his responsibilities and authorities yet felt he should be given more authority as well as responsibility. He stated his superior's influence in the areas that he should make the decision, as a constraint imposed on him.

The difference in the responses of these three managers singles out the ever lasting situation. People are different, therefore their expectations and perceptions are different. Here we have a manager saying that he could do better job if he had more freedom as well as responsibility. In the same organization we have two

other managers that feel happy with their situation. As one manager in Kanoo stated, " you have to accept the situation and try to adapt to it, otherwise the situation becomes very difficult to survive".

3.1.2-BANKS

In total 16 questionnaires were collected from managers in six different banks. Six out of all managers believed that they did not have enough authority to carry out their duties and control cost and revenues of their costs. Again the same issue of contradictory responses from the same organization was faced in banks as well. These contradictory responses are not from different levels of management in the organization. That could be explained by different management styles in the management layers in the organization . My concern is regarding the differing degree of authority granted or the ability to obtain approvals in the same organizational management layer.

The responses from Al-Ahli Commercial Bank pointed out the organization as a centralized one, with a mismatch between responsibilities and authorities with a very low level of authority delegated. The performance evaluation of the manager is in direct connection with the economic performance of the department and no distinction between the two is made. Regarding the reward system it seems that not a general rule exists in the bank. The

credit manager said that he was rewarded for outperforming the profit plan, yet a branch manager stated otherwise. I guess these differences are the results of direct superiors decisions.

However, I believe that for such important issues there must be a policy to be followed by all management layers. If nobody is rewarded for outperformances the conflict and demotivation is less than if one is rewarded and other one is not. In regard to calculating the profit of each profit center, not a single format could be seen. For credit division centralized costs are not allocated but for the branch these costs are allocated and included in calculating the net income of the branch. This may explain the gap between the level of non-controllable costs in the two centers. In credit division 70 percent of the costs are considered non-controllable and the branch manager finds 95 percent of his costs non-controllable.

When asked regarding the management performance evaluation process, the branch manager stated that he had no idea on what basis this was done. On the other hand the credit division manager was clear that it would be based on the quality of risk assets and control over them, profit of the bank and personal development of manager and of course the budget achievement. To me it seems that communication channels between the branch manager and his superior or main office are not working effectively and a lot remains to be desired.

From Bank of Bahrain and Kuwait (B.B.K) I received surprising responses regarding the organizational structure, one group stating that it is a decentralized organization, other stating that it is a centralized one. I believe the first group is referring to organizational structure on paper and documents and the latter is referring to the practices of management team. This is the conclusion that I arrived at after three interviews with the different managers. The management filter as introduced previously, is not practiced in the bank. The top management feels that if a manager has a project or objective to achieve it is his duty to see it to be carried out properly, disregarding the effects of other managers' actions upon the achievement of the goal.

Budgets are handed down from the superiors to the senior manager and, as I understand it, he will be wise not to ask for too many modifications. For each department, profit is calculated after deducting direct expenses and allocated support departments costs. No rent is charged and no other transfer pricing takes place between the departments. For example, if a branch brings business for other branch no commission charge is made.

The manager of commercial individual banking department believes that the bank lacks proper management information system (MIS) and the right implementation of profit center concept. This statement in itself partly explains the discrepancy in responses collected.

Management performance evaluation is based on budgets which are basically laid down by the managers' superiors.

The Bahraini branch of Bank of Oman seems to experience a lot of restrictions from its head office. The limits on maximum authorized expenditure are too low; investments have to be approved by a committee in head office; lending transactions and policies are tightly controlled. And there is no distinction made between the branch's economic performance and that of its management.

In case of common revenue matters, all the credit goes to the unit from which the service have been provided to the customers. Common costs are settled on the basis of preset percentages and centralized costs are allocated and included in calculating the net income.

In total, managers in the bank seem demotivated and stated dissatisfaction for the tight controls imposed on their operations.

From ABN Bank I received only one questionnaire and that pointed to credit limitations as constraints imposed on branch manager, and to the very strong correlation between the branch's economic performance and the management performance evaluation.

In Gulf International Bank (GIB) I observed a two sided utilization of profit center concept. On one hand top management tightly controls expenditures; deals are made within restricted limits and frequent references to boss for approvals are needed. In this aspect the management style does not correspond to a more

flexible style that is preferred for implementing profit center concept.

On the other hand, GIB is one of those banks that have the right format for calculating profits of the units as advised for profit centers. For example, though the bank owns the premises, each division is charged rent according to square feet of the area occupied. In interdepartmental monetary transactions interest is paid and received and these interest charges are compatible with market rates.

Common costs are allocated on the basis of previously decided criterion, and the credit for common revenues goes to the unit initiating the deal. Centralized costs are allocated but appear as a separate item in the income statement, therefore denoting the center's profit before and after such allocations.

Managers have active participation in developing budgets for their centers, and for this reason their performance evaluation is closely related to achievement of the budget.

Two out of five respondents found the management control system in GIB demotivating, referring to close supervisions in their daily activities.

Standard Chartered Bank is another bank in which the implementation of profit center concept as a management control tool is in acceptable levels. However, this move toward profit center establishment has been initiated 18 months ago. Prior to that

the bank was so profitable that the management did not care to know which division was bringing most of the business in. However, the economic changes caused changes in customers. They became more specialized requiring more specialized employees with higher salaries in the face of declining margins. Initially my two interviews one in Diplomatic area branch and another in Manama branch, yielded contradictory results. One emphasizing the use of profit centers as a management control tool, the other pointing to a centralized and wholeness approach in management.

In a second follow-up interview the surprising reason for this deviations became evident. Strangely enough the answer was that since this was a new system not all managers were aware of it. To me, this was the most unacceptable excuse. First of all, I believe that before the implementation of such systems all managers should be informed and their participation and input in making the system work is a must. Secondly, how can one measure a manager's performance without letting him know on what basis he is being evaluated? Obviously the performance results of those managers informed about the new system will be different from the rest both in economic and managerial terms.

Beside this disadvantage on regarding the way profit centers were established in the bank, the divisionalization and the system adopted is a good one.

In Standard Chartered there are basically three major profit centers: 1. Corporate finance 2. Treasury and 3. Retail.

Rents, electricity, maintenance, personnel and other such support department costs are allocated to each division on different basis. When possible the change will be according to actual usage like computers, maintenance, personnel. Otherwise an arbitrary criterion for allocation will be chosen. Management believes that sometimes the time and money put to find the perfect criterion and transfer price is not justified by the benefits gained.

The savings of retail centers are lent to corporate finance center on the basis of three months inter-bank rates prevailing at the time. London's head-office costs are allocated to regional branches on the basis of their profitability. Here it seems that the regional banks are being penalized for their profitability. The logic for such allocation is offered by the management as follow : sometimes a regional bank is newly established. It will have high costs and low revenue, therefore if it contributes for covering some of head office's costs it will suffer losses. It is only fair that more profitable units contribute more to cover the head-office costs. Also, the top management believes that one could always argue no matter what allocation base is used. Therefore in situations like this any allocation base is as good as the other.

In developing the budgets the relevant manager is an important participator. Along with budget the manager should prepare a list of objectives for his department. Manager and his superior

will decide on the budget and the list of objectives. The center's management has the right not to sign his acceptance if he does not believe in the level of the budget set or the objectives laid down for him. Due to this flexibility in setting these two documents, the managers's performance evaluation is directly and closely related to achieving them. Any deviation needs detail explanation. In these respects management control systems seem motivating in Standard Chartered Bank. However, there is one pitfall and that is the existence of two types of officers or managers in the organization. One is the international officers which are the normal employees of the bank. The other is the contract officers who are like special task force and are employed on contract base to achieve a certain goal. There is a conflict of interest between the two group. The contract officers are normally more aggressive. They know that they have limited time frame and their extra bonus depends on the achievement of the objective. They always have more authority than an international officer in the same rank. Because the addition of contract officers temporarily changes the organizational structure to a matrix one .

Contract officers normally use their high authority in aggressive ways to get to their objective, not caring for the aftermath results knowing that they will not be there to face them. After they leave it is the international officer who has to face the mess that the contract officer has created. The international officers believe that if they are given the authority enjoyed by

contract officers along with only a portion of their salary or bonus, they could as well achieve the goal desired in a more systematic way without endangering the institution's future.

Though at the beginning of the year the international officer could mention the correction of situations made by contract officer as their objective, yet they believe this requires a lot of work that is not really helping the bank to achieve its overall objective.

In respect to bonuses and rewards, the regional manager usually receives a substantial bonus at the end of the year for a job well done. He has discretionary authority to share this bonus with his employees or to keep it all to himself. Up to now the usual practice has been the sharing of bonuses as a motivating factor for managers, because they believe that it is their subordinate's activities that have contributed to the high profits of the region.

3.1.3-Insurance Companies

From insurance companies, Northen Assurance Co. Ltd. and Arab Insurance Group (ARIG) were contacted as a sample of insurance companies.

The interview with a manager in Northen Assurance Co. resulted in the fact that this organization is not divisionalized to profit centers. The reason offered by the management was that since

they are a service providing organization they do not see the logic in establishing profit centers. Management believes since there are no tangible goods to attach price and cost of production, it is difficult to talk about insurance services as profit centers. Another reason given was that in insurance companies the revenue and costs do not have a systematic pattern. For one month they have high revenue due to premiums collected, in another a high payment to a client makes a certain department show negative results.

Of course these are not very valid reasons for not establishing profit centers, because there are insurance companies that are divided into profit centers as we will see in ARIG's case. Two reasons that come into mind for an insurance company not being able to establish profit centers are; First, none existence of a good and proper MIS system. We know that the initial step in establishing profit centers is the establishment of a good MIS system which can be very costly and time consuming. The second reason could be the type and volume of business. If for a certain company a major portion of their revenue is generated by one line of business and others work as complimentary to that line, then there is no pressing need to establish profit centers.

There are eleven profit centers in Arab Insurance Group (ARIG), ten of which are the re- insurance businesses and the other one is the investment department. Support departments' costs are allocated on the basis of different criteria. Finance depart-

ment's costs are allocated on the basis of time spent for reach departments accounts and transactions. This is an approximation done by the finance manager.

Claims department charges each department directly, based on the number of climes it processes for that department. Computer and communication departments' costs are also allocated on exact usage for each department. The personnel department's costs are divided between other departments based on the number of employees. However, the general administration and public relation costs are allocated based on the premium generated by each department. Once again it seems that a unit is being penalized for its profitability (example of Standard Chartered). The reason offered for such allocation base is the same, and that is that the more profitable units are better able to cover these costs. They believe that after all they are only one organization and there is no logic to hamper weaker departments by allocating these costs equally.

Rents and electricity are charged per square footage of occupancy.

On the management style side, there are constraints imposed on the managers regarding types of business that can be accepted. In my opinion this is in contrast to profit center concept. Surely there must be some guidelines but, interfering with businesses accepted directly is not the true profit center concept's spirit. When the manager is responsible for the profit of its unit he

should be responsible for generating that revenue and the adequate authority should be delegated to him. In this case it seems not only authority of the center's manger is limited, but also his responsibilities are reduced as well. One motivating factor in managerial level is the higher responsibilities and authorities associated with each higher level, therefore taking it away, definitely will have some demotivating effects.

Managers' other complain was that the costs of support departments are allocated on the basis determined by top management, and not all managers feel that they are the best choices.

The development of budget is done by department head, division head and the general manager. My understanding during interview was that the general manager has a heavy weight in the decision making process regarding budgets.

It seems what we have here is an organization divisionalized as profit centers but with an authoritative top management, which is not the only example of such cases.

3.1.4-ALBA

ALBA is not a profit making company in itself, but the making of profit is left to its marketing and sales company BALCO. Yet, surprisingly the questionnaires that I received from different managers in ALBA pointed them as profit center managers. I be-

lieve this is in line with those literature saying that saving money is making money, therefore it is the costs saving activities of the centers that makes them profit centers.

However, it seems that not a great majority of managers in ALBA enjoy enough authority in line with their responsibilities since only one out of four respondents stated that he had a matching authority and responsibility.

The whole management control system is not perceived motivating and the organization lacks organizational culture and sense of unity.

Different managers could and are causing problems for each other and there is not much good relationship between high level management and the lower level. This could be a good case for implementing management filter concept, preventing managers in the same rank from negatively effecting each other's work.

No monetary reward is received for out performing budget and the promotional prospects of middle level management do not seem very bright. In production and service of production group departments common costs are equally divided. But in carbox production department and another one (the respondent failed to specify the department) a preset percentage is used to allocated common costs.

Regarding the system of preparing budget, not a unified system was detected from the questionnaires.

3.1.5-BALCO

Bahrain Aluminium Company is the marketing Agency for the products of ALBA. Its current name is Bahrain Saudi Aluminium Marketing Company, yet it remains to be called as BALCO. It was first initiated as a separate body from ALBA in 1970 since when it has gone through changes in respect to operations as well as ownership of the company. The present owners are 74.9% Bahrain government, 20% Saudi Public Investment Fund, and 5.1% Breton Company.

Though this is a marketing and sales agent for ALBA, yet it acts as a separate company and buys ALBA's product at cost. Since ALBA and BALCO have the same owners there seems no logic in paying profit to ALBA. In this way ALBA will always cover its costs and BALCO will act as a subsidiary to genera profit. Therefore it looks like a profit center extension of ALBA. BALCO in itself is not a big company and consists of maximum ten employees, therefore within BALCO we do not see different profit centers. However an expansion is being planned and divisionalization into profit centers is planned as well.

BALCO's sales and dealings mostly are done over the phone with the help of a computerized system that provides the latest movements in the world market. Due to the nature of the way deals are closed, BALCO's general manager enjoys extensive authority much more than most government owned organizations. In BALCO

there is no time to go back to the boss or board of directors to ask for approvals.

Another issue is that aluminium market is like commodity or stock market where you can engage in futures and forward transactions. This is the job of the general manager to forecast the future moves of the market and if necessary undertake some futures deals. The profit of the organization mainly depends on this ability to forecast the future accurately, since if the forecast is not correct the chances of rectifying the position is very slight. This is in direct contrast to some literature saying that managers should not be evaluated on the basis of their forecasting abilities but on their managerial capabilities. Here the main job of the general manager is to forecast the future and do it accurately.

3.1.6-Yousif Bin Ahmed Kanoo

Kanoo organization is mostly known by its travel agency business. In fact Kanoo is a well diversified organization with head offices out of Bahrain as well. The following is a list of businesses that Kanoo is engaged in :

- 1- Freight services : is an agency business for sea lines.
- 2- Clearing and forwarding services: this is complementary to freight services. In total both undertake shipping, and all details regarding clearing goods from the customs.
- 3- Travel agencies: which includes Holidays and Inbound tours

as well.

There are two types of agencies for airlines in Kanoo. They are general sales agent for 22 airlines, where these airlines have no office here in Bahrain but their tickets are sold through Kanoo.

Examples are British Airways - Air India- Lufthansa Air PIA. Unfortunately due to recent crisis in the region some of these flights have ceased operation in Bahrain .

The other is that Kanoo is the agency but the airline has an office here.

Examples are Middle East Airline-SAS-Olympic Airlines-Cypros Airline.

4- Commercial division: which to a certain extent is a misnomer. This is a trading division mostly involved in machinery, equipment, chemicals, building materials. The stocks are bought from the seller and sold in the market for profit.

5- Consumer product division: This is an agency business-Kanoo is the agent for a lot of consumer goods such as cigarettes, tobacco, detergent, shampoo, soaps.

The above mentioned lines of businesses are arranged as profit centers and this divisionalization took place in 1980.

There are support departments such as computers, communications general administration (corresponds to personnel), general man-

agement, and central accounting.

Computer costs are allocated on the basis of number of entries. Communication costs also can be exactly traced down to each department.

General administration costs are allocated based on the number of employees, and the general management costs are deducted from the consolidated income statement. The costs of central accounting division is allocated based on its management judgment regarding the time and effort put for each division.

Rents are charged to profit centers even if the occupied premises is owned by the organization. The electricity is charged based on the square footage as well. There are other support departments as well such as reservation and refund. Their cost is not allocated but is deducted from the travel agency's consolidated income statement.

There is a sales office in the airport which sales tickets for all airlines dealing with Kanoo. The costs of this office is allocated to different airlines on the basis of number of flights coming to Bahrain from each airline.

At times there are transactions between divisions. For example the freight and services division undertakes the delivery of goods for commercial or consumer products division. In these cases it will charge the relevant division its cost plus commission.

From the management control point of view, Kanoo like most other family owned businesses is a closely controlled organization. For example any expens beyond BD 250 needs board approvals.

Budgets to get a final approval have to go through a long channel. First the manager of the department sets the budget subject to senior management approval, subject to local board approval, subject to group board approval. Then these budgets are entered into the computers and there is a monthly management report meeting. A maximum of five percent range for deviation from budgets is allowed.

During interviews it was evident that more authority could have tremendous motivating effect and it would make managers jobs easier. Some felt that they spent too much time on getting approvals for their daily activities. Those content with the situation believed that one should get used to the system and there is no point in trying to change it.

3.1.7-Bahrain Maritime and Mercantile International B.S.C. (BMMI)

BMMI is another diversified company which is an associate of the Gray Mackenzie group of companies. Their business is divided into following profit centers.

- 1- Liquors.
- 2- Consumer goods; they are the agent for Craft, Lipton, Faa and some other products.

- 3- Industrial goods; which is an agency business.
- 4- Travel agency.
- 5- Insurance (Royal assurance).
- 6- Shipping .
- 7- Supermarket.

From the above, only industrial goods division have been negatively affected by the crises in the region .

The company pays five percent of its profit to Gray Mackenzie.

In BMMI no rent is charged to divisions, and general administrative costs and finance and accounting department's costs are not allocated. Therefore each center's profit is calculated by deducting the direct expenses of the division only.

However, the company is planning a new system in which interest will be charged to those units that use cash generated by other departments. For example shipping division usually has excess cash because they receive their money before the actual shipment takes place.

There are divisions that have positive working capital for the period. Previously the need was filled from the centralized pool of funds, but in the new system the shipping division will receive interest for its money and the other department will be charged interest.

Budget is set by division manager, subject to approval by general manager and finance manager. Afterwards it will be presented in

a meeting to people from Gray Mackenzie, since the higher the profit of BMMI, the higher their profit as well.

Beside the budget the management is to establish measurable objectives for his department. These two; budget and the list of objectives, are the criteria for evaluating the managers.

I felt managers were happy with their situation since their income statement included only direct costs that are controllable and no other costs were charged to them. And they felt they had enough authority to do their job. However, I do not believe what we have in BMMI is true profit center concept implemented. They lack the proper allocation technique. In fact there is no allocation at all .

4-SUMMARY AND CONCLUSION

The different patterns of behavior and practice of individual organizations in the same industry have not permitted me to make industry-wide generalizations. Only hotels, but to a certain degree, show a similar pattern in calculating the profit of their two profit centers. But, in my opinion, what they present is only a miniature of the profit center concept as is the case with BMMI(Bahrain Maritime and Mercantil) and any other organization that includes only the direct expenses of the division in calculating profits of the division. If the costs of support departments such as computers, communication, and maintenance are not charged to the profit centers, the managers will be encouraged to either misuse the services rendered or not use them at all. This definitely will not be an efficient and effective way to achieve the organizational goals. The general administrative and management costs should be allocated but appear as a separate item.

The allocation criterion should be such that it reflects the actual use these services by the profit center.

I was disappointed with the approach of local commercial banks to the profit center concept. My initial feelings were that I would find real profit centers in the banks which could be used as a benchmark to evaluate other industries. However, Al-Ahli Commercial Bank and Bank of Bahrain and Kuwait were not found to be representatives of true profit centers due to both their methods of accounting for profits and top management style.

Standard Chartered Bank provided a good example of true profit center, but given the facts that the system was implemented without participation of the affected managers, and there are still some managers that are not aware of the system even 18 months after it's installation, prove a pitfall in the system, and I believe that the inputs of these uninformed managers could prove very useful.

Kanoo presents a very good example for management control through profit centers, at least on accounting side of it. But the strict and rigid management style makes the system dysfunctional to a large degree. During my interviews I realized that a more flexible board of directors and top executive could push the company even further in its success.

One thing that was encouraging in all organizations studied was *the fact that management performance was not evaluated based on ROI or ROA or some other ratio. Rather, budgets, and, in some organizations, budgets plus a list of objectives were the criteria for evaluation. However, the manner in which the budgets were developed were different. For example, in B.B.K. the budgets are prepared by the superior, which even more makes their profit centers fictitious ones. But standard Chartered Bank and Regency Intercontinental Hotel use a participative approach in developing their budgets.

One point I would like to make is the lack of professionalism in some management practitioners in the organizations. This was

more evident in hotels, but was not limited to them. Managers of profit centers sometimes did not know how their division's profit was arrived at. This definitely has some effects on their practices. For example if they do not know that they are charged for computer costs based on usage, they tend to use it for things that really do not need any computer help.

The aim of this research was to examine the existence of profit centers in Bahraini organizations. The results that I have concluded are as follow :

- 1-There are profit centers used as part of management control systems in Bahraini organizations.

- 2-Whether these profit centers are true or fictitious ones differes extremely from organization to organization. Some companies like Kanoo exhibit almost a perfect set up, except for their management style. Some like BMMI and hotels are on the weak side of the implementation.

- 3-As mentioned before in the theoritical part of the research, the right implementation of profit center concepts requires an adequate management information system and a sound management philosophy.

Even if all the technicalities are provided for the implementation of profit center concept, any managerial reluctance to delegate authority, as is noticed in most organiza-tions in Bahrain, then we will hinder the estab-

lishment of true profit centers. Instead something close to it, which can be called fictitious profit centers, would be observed.

4-The much feared practice of basing a manager's performance on certain ratios does not exist in Bahraini organizations.

5-When centralized costs of headquarters are allocated, no attempt is made to break them down into controllable and non contrallable costs.

6-In fact, even during the interviews the concept of controllability of costs is not very clear to most managers.

7-Management education on the field of profit center concept is needed to broaden the horizons of top executives and to teach the lower level management how it should be implemented .

8-In almost all organizations a lack of participation by middle and lower level management has been observed. I consider this very harmful to the objectives of the companies.

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APPENDIX A

Dear Sir / Madam :

In compliance with M.B.A.(Masters in Business Administration) program in Bahrain University , as the last stage we are required to submit a thesis based on theoretical work supported by empirical evidence .

The title of my thesis is "The Use of Profit Centers by Bahrainy Organizations in Their Management Control Systems" .

In this regard I would appreciate your response to the questionnaire . Please feel free to add any comments where you feel fit .

The confidentiality of your answers is reassured by the fact that no name is asked . Just kindly state which business is your organization in at the bottom of this page .

Sincerely yours ,

Khandan Jazayri

1- Do you consider your organization to be centralized or decentralized ?

a-centralized

b-decentralized

2- Is your organization divided into responsibility centers?

a- yes

b- no

3- If yes , which one of the following is the type of divisionalization in your organization ?

a-cost center

b-profit center

c-revenue center

d-investment center

4-Are you a profit center manager ?

a-yes

b- no

If the answer is no , please do not continue answering the questioner.

5-Which profit center are you manager of ?

6-Do you think in your organization responsibility and authority are delegated down equally ?

a-yes

b-no

7-Do you think you have enough authority to control your division's cost and revenue ?

a-yes

b-no

8-What type of constraints are imposed on you ? Pleas explain

9-As the manager of a profit center do you feel your performance

is directly measured against the center's profit performance?

a-yes

b-no

9-In your organization's policies , is there a distinction between management performance and the center's performance ?

a-yes

b-no

10-Does your immediate boss measure your performance accordingly ?

a-yes

b-no

11-Are you rewarded for out-performing the profit plan ?

a-yes

b-no

12-If yes, is the reward in monetary terms ?

a-yes

b-no

13-If yes , do you find this monetary reward adequate ?

a-yes

b-no

14-Do you find the management performance control in your organization motivating ?

a-yes

b-no

15-How is the profit performance of the center measured ?

a-as the direct contribution margin

b-as direct division profit

c-as controllable division profit

d-as income before tax

e-as net income

16- If the profitability is measured as the contribution margin , how do you define the contribution margin ?

a-revenue minus controllable divisional profit

b-revenue minus fixed expenses

17-Which one of the following situations you face in your profit center ?

a-common costs

b-common revenue

c-transfer pricing

18- How do you resolve common revenue problems ?

a-all the credit goes to the unit initiating the deal

b-all the credit goes to the unit from which the goods or service have been issued to the customer

c-share the revenue equally between the profit centers involved

d-a commission base is used

e-any other, please explain

19-How do you solve common cost problems ?

a-share the cost equally among the relevant centers

b-a preset percentage base is used

c-any other , please explain

20-How are the transfer prices set ?

a-at actual cost

b-at market price

c-by negotiation

21-What percentage of your revenue you find controllable?

22-What percentage of your cost you find non-controllable ?

23-Please list the main controllable and non-controllable costs in your profit center :

a-Controllable

b-Non controllable

24-Do you find any discrepancy in what you consider controllable cost and what you are held responsible for ?

a-yes

b-no

25-If yes , pleas specify.

26-How are centralized costs allocated to your profit center

a-they are not allocated

b-they are allocated but appear as a separate item on the income statement

c-they are allocated and are included in calculating the net income

27-Is there a preset minimum target profit ratio that your profit center should keep up with ?

a-yes

b-no

If yes, pleas specify .

28-On what basis your performance as the manager of a profit center is measured ?

29-Is there a profit planning program for your profit center ?

a-yes

b-no

30-If yes , who are involved in preparing it ?(Please state in sequential numbers to denote importance .)