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Three-Way Path to Fair Analysis of Performance

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Is the operating manager being burdened with an unfair share of the company's costs? Clearer performance reporting, measuring his unit's contribution, is needed.

Budgeting gives quantitative expression to plans. Budgetary control involves extracting significant deviations from the budget in the form of variances and analysing these in order to assess and control events. Care is needed in the way budget and performance information is presented, because this is likely to influence its reception.

A way of setting out the information, based on its segregation into those items which the operating manager can and cannot control, will help in the appropriate and efficient analysis of various aspects of the organisation's performance.

For simplicity, in the following discussion the word 'unit' will be used to mean either a department or other operating unit or the enterprise as a whole. What is said will be equally applicable to all levels within the organisation.

An initial step in budgetary control concerns the classification of costs. This is because it is important to draw a distinction, for control purposes, between:

- fixed and variable costs,
- indirect and direct costs, and
- controllable and uncontrollable costs.

Fixed costs are those not affected by the level of output over the time period being considered. Examples of fixed costs include the costs of managing a unit, the occupancy costs of rent, rates and so on, all of which tend to remain the same whether the unit produces at 60%, 90% or some other percentage of capacity.

Variable costs are related to the level of output, although not necessarily having a linear relationship with it. Examples of variable costs include the cost of the direct materials used in production, royalty payments and the use of power directly related to the levels of production.

Indirect costs are expenses which are jointly incurred by a number of different cost centres. Thus, for a manufacturer who produces a number of products, at different units but for the same market, an advertising expense incurred by jointly advertising all of those products in a particular publication will have to be allocated between the various units concerned. In the large organisation, the general manager's salary will have to be apportioned over a number of departmental cost centres. In the production unit, consumables will be allocated over the different products.

Direct costs are those costs or expenses directly attributable to a cost centre, that is the operating unit, and the 'directness' will depend upon the level of the unit being considered. Direct costs in any factory department will include costs of production, ie those costs associated with raw materials used direct labour, direct expenses and so on.

Controllable costs are those over which the operating manager has some control, although this may be only within certain limits – for example, the power used to heat his department, or the cost associated with substandard production due to insufficient training and supervision of operatives. Uncontrollable costs are those 'imposed' on the operating manager, such as the rent for his unit negotiated by higher management, or the rates dictated by the local authority.

Three points arise from the above classifications:

1. Although the classification of a cost within any of the three groupings – fixed and variable; indirect and direct; controllable and uncontrollable – is mutually exclusive, ie elements of a cost must be either fixed or variable, there is no mutual exclusivity as far as the classification of a cost as between the three groupings is concerned. A cost can be, for example, fixed, indirect, and uncontrollable at one and the same time.

2. Fixed costs are not necessarily indirect costs, and neither are variable costs always direct.

3. It is crucial in budgetary control, for motivational reasons, to distinguish between whether a cost is controllable or uncontrollable.

Obviously, at the extreme, somebody somewhere, within any business, must ultimately be able to control any cost that the organisation faces. This may be even to the extent of deciding whether to close the firm down, which effectively ‘controls’ a normally uncontrollable expense such as local authority rates, by stopping the cost from being incurred in the future.

As one goes down the hierarchy of management, it is usual to find that successive managers at lower and lower levels have less and less control over the expenses necessary for the operation over which they are responsible. For example, the manager of a shop floor production unit is unlikely to have control over the rent an organisation is likely to be faced with. This cost would be apportioned to cost centres. Such an apportionment is unlikely to have been made carelessly, and usually will have some apparently logical basis. So one important question about the apportionment revolves around whether it has been made using the most appropriate method taking into account the circumstances of the group’s cost centres. The only indisputable fact is that any apportionment of indirect costs provides an uncontrollable cost for the manager receiving the apportionment.

A budgetary control report should be structured in a way which both highlights the performance of the unit and enables an analysis of the unit’s overall contribution to the company’s performance to be made. The most appropriate layout for providing performance and other information for an operating unit is to use a basically three-section approach.

A layout such as that suggested below will help in the analysis of the information by showing a unit’s contribution towards central costs and the company’s overall profit. It also provides helpful information for comparing performance as between units, and effectively enables the efficiency of the operating manager of the unit to be appraised.

Items are entered in the various sections of the report depending upon their directness and the degree of control that the manager can exert upon them.

The example provided is for a production unit. Although here its manager is unlikely to be able to influence the sales of what his department manufactures, assuming that the product specification is met and there are no capacity constraints, these sales are nevertheless included. This is a common practice because the production manager, who does influence the costs of his unit’s production, should know the difference between sales values and production and other costs.

The information in the figure can be analysed as follows. The controllable direct items are shown in the top section of the report and are within the manager's span of control. The costs in the second section are those negotiated by headquarters for the space that his department uses; or the hourly rate paid to employees in his unit, although he may have some control over the number of hours of overtime that he authorises them to work.

All this means that care has to be taken in the classification of costs for control and appraisal – different classifications will be needed for different purposes.

From the foregoing, it can be seen that an operating manager rarely has control over the fixed costs associated with his unit's operations. However, he may have influence over some fixed costs, such as those associated with repairs, through the use of preventive maintenance. It is generally only some aspects of the variable costs of his unit over which he is likely to have significant influence.

Even then, it is only those variable costs which can be classified as direct that are likely to be controllable by him. He is unlikely to be able to influence the indirect costs apportioned to his department by headquarters, such as its share of the central and administrative costs that the firm has to pay – other than through protesting about the level of apportionment.

The question of allocating indirect costs is important, since each department within the organisation must bear its share of overhead. By their very nature, they will also be the direct items of the unit that is being controlled. The manager can use overtime and heating and lighting as economically as possible, and as he has some sort of control over the cost of these and similar items, they will be entered in this section.

Because the manager has a degree of control over items in the top section, it is against the summary of this information – which leads to the controllable direct contribution – that his performance should be appraised.

However, the unit itself must make a positive contribution. To appraise performance in this respect, the uncontrollable costs directly incurred, such as rent, rates, the depreciation of the unit's fixed assets, and so on, must be brought into the analysis. These are entered in the middle section of the report. The deduction of the total of the items in this section from the controllable direct contribution leads to the direct contribution of the unit towards the group's overall performance.

Suggested Layout for a Unit's Contribution to Costs and Profit					
Section		**Fixed Budget £000's**	**Flexed Budget £000's**	**Actual £000's**	**Variance £000's**
Top	Controllable Direct Items				
	Sales	120	106	106	-
	Cost of raw materials	58	60	61	(1)
	Wages and salaries	15	15	14	1
	Occupancy costs (eg heat, power etc)	2	2	2	-
	Other (eg packaging etc)	1	1	1	-
	Cost of Production	76	78	78	-
	Controllable Direct Contribution	26	28	28	-
Middle	Uncontrollable Directly Relevant Items				
	Occupancy costs (rent, rates etc)	8	8	10	(2)
	Other (including depreciation)	4	4	4	-
	(These overheads are directly relevant to operating the unit/cost centre) Depreciation for example would be directly allocated	12	12	14	(2)
	Direct Contribution	14	16	14	(2)
Bottom	Uncontrollable Indirect Costs				
	Marketing and sales costs	10	10	10	-
	Central administration costs	3	3	5	(2)
	(apportioned items)	13	13	15	(2)
	Profit/Loss of Unit	1	3	(1)	(4)
Reconciliation with fixed budget	Increase/(decrease) in profit attributed to increase/(decrease) in sales (ie flexed budget profit less fixed budget profit)				2
		1	**N/A**	**(1)**	**(2)**

Notes:
1 The fixed budget must be flexed to enable variance analysis to take place.
2 Unfavourable variances are shown in brackets.
3 Although the bottom level items concern uncontrollable costs allocated to the unit, they could also be divided into those costs which were, and were not, controllable by higher authorities.
4 In practice, the figure can contain up to some 30 itemised costs appropriate to the cost circumstances of the unit.

It is information on this direct contribution that should be used in decisions concerning how viable a production unit really is. The direct contribution must be allowed to continue to exist, unless there are special circumstances which necessitate it operating on a negative contribution basis.

The figure arrived at can also be used to rank the direct contributions of the various units operating within the organisation. However, such a simple comparison is not enough: the investment in the unit, and other investment opportunities available to the firm, must also be brought into the analysis before the relative performance of units within the group can be ascertained, and decisions made about the optimum use of the organisation's resources.

Any central costs apportioned to the unit go in the bottom section of the report, because such costs must eventually be covered by the group. Their total is deducted from the direct contribution to show the recorded profit or loss of the unit, based on the accounting policies used.

However, the result does not necessarily provide a figure upon which decisions about the unit's future should be based. As long as a unit is making some direct contribution towards the group's central costs, which information can be ascertained from the middle section of the report, and while there are no other better investment opportunities open to the enterprise, the unit should be allowed to remain in operation. To close it would cause the organisation to make an even smaller overall profit – unless the closure enabled a greater reduction in the enterprise's central overheads than the contribution foregone.

It could be argued that any costs which are likely to be reduced on closedown should have been worked into the middle section of the report. And this is all assuming that the costs in the top two sections can be saved through the closure of the unit.

An analysis of the budget and operational results provided in the figure helps in the understanding of the benefits associated with the three-section approach. In the top section, it can be seen that the unit has bettered its budget with sales and controllable direct contribution but the direct contribution is only as budgeted. The gains from the top section have been 'lost' to rent increases which were at a level beyond that budgeted for. However, the manager was not involved in negotiating rent and so had no control over this or any of the other figures in the middle section.

The bottom section shows that the unit reported an overall loss instead of achieving the overall profit which was budgeted. This was because more headquarters costs had been apportioned to it than were originally budgeted for. It is not, however, a signal to close the unit down, but merely points to a need to investigate the level and the apportion of costs from headquarters.

Such an investigation should ask whether central costs give value for money and are necessary at the levels shown. It must be borne in mind that those costs must be covered by the organisation in some way if it is to survive. A further question to be asked is whether it is necessary to apportion the costs at all and if so, whether the method of apportionment is fair. The analysis must always have regard to the fact that if the unit is closed down, and the headquarters costs cannot be reduced, the proportion formerly provided by the unit will still have to be recovered from the units which continue to operate.

In summary, an important aspect of the use of budgetary control concerns its acceptance by operating managers – their acceptance of the technique is strongly

influenced by them seeing that it reports their performance in a fair way. The three-section approach does this, and has the added advantage of providing information to management in a way that clearly segregates it for different purposes.