Cost & Profit Centres

Dividing large businesses up into manageable parts

Cost Centres

- Production units that generate costs but no revenues. eg the Maths and Humanities departments at a school. Costs will include salaries, teaching resources and equipment used.

Profit Centres

- Businesses that are divided into parts that generate both costs and revenues. Allows separate profit calculation for each centre.
- Costs and revenues should be easily attributable to the centre.
- eg the different departments in a department store.

Benefits

- Financial discipline. Enables managers to monitor costs more effectively.
- Can identify the areas of a business that are performing well and those that are not.
- Allows managers to allocate costs and revenues for each centre, leading to a profit figure.

Benefits

- Managers can use it to switch resources to the better-performing centres.
- Allows for benchmarking (comparisons between centres)
- Can be motivating for managers of centres.

Drawbacks

- Can be difficult to allocate indirect costs fairly between centres.
- Profits of centres will change depending on how indirect costs are apportioned.
- Poor performance may be due to external factors that are not recognised in the profits centre calculation.

Drawbacks

- Data collection to manage cost and profit centres takes up valuable time and adds to costs of administration.
- May promote unhealthy rivalries between centres.
- Added costs of training staff to look at centres.

Drawbacks

- Isolating centres ignores benefits of cross-selling. eg Xbox and computer games. The Xbox makes very little profit for Microsoft, but they still make it because gamers need it to play the very profitable games that Microsoft also produces.

Apportioning Overheads

- Full Costing
- Absorption Costing

Full Costing

- Total fixed costs are divided between centres according to one agreed formula eg % of workforce employed.

Absorption Costing

- Individual fixed costs are divided up using different methods.
    - rent via area of factory used by a centre
    - Marketing costs via % of sales revenue etc.

Allocating costs

Level 7 is an independent tuition college that runs IB revision courses in Art, Business, Chemistry and Design. Its indirect costs are $3,000 per month. Details of its costs and revenues are as follows:

Department	Art	Business	Chemistry	Design
Tuition fee ($ per hour)	$35	$40	$38	$32
Customers (hours per month)	225	125	320	185

a Calculate the monthly sales revenue for each profit centre. *[2 marks]*

b Apportion the overheads according to sales revenue for each profit centre. *[6 marks]*

c From your answer to Question 5b, calculate the contribution made by each profit centre. *[4 marks]*

d Explain one other criterion that *Level 7* could use to allocate its indirect costs. *[3 marks]*