



DEPARTMENTALIZATION

A Useful Management Tool for Your Firm?

By Drs. John Foltz & Christine Wilson

Do you know what areas of your business earn the most profit? Do some of your departments subsidize others? Are there some products and/or services that you offer strictly as a service to customers, and thus you do not count on them to be profitable? Finally . . . does it matter if you know the answer to these questions as long as your overall business is profitable? In this month's column we will talk about the process of departmentalization — looking at your business by department or profit center.

Departmentalization - What is it?

To start with, departmentalization can be thought of from an organizational standpoint or a financial standpoint, or both. We will talk about the approach from a financial standpoint in further detail below, but first let's discuss departmentalization from an organizational point of view.

Looking at how your business is organized, departmentalization is the subdivision and assignment of work. The most widely recognized methods of departmen-

talization are by: function, place, product and customer.

Functional departmentalization

Functional departmentalization groups people by expertise and resources used. It is the most widely used and accepted form of departmentalization. It can be very efficient and economical because it promotes skill specialization and reduces duplication of resources and increases coordination within the functional area. This approach also enhances career development and training within the department, while also allowing

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superiors and subordinates to share common expertise.

The functional method promotes high quality technical problem solving and helps to centralize decision-making. Examples of delineating departments using this approach would be using departments like: sales, production, credit, purchasing, human resources and research.

Disadvantages to the functional

approach include the fact that it emphasizes routine tasks — meaning employees may become complacent or bored. The method also reduces communication between departments, which discourages overall company teamwork and creates narrow perspectives since employees may not see how the entire business operates. In addition, functional departmentalization

may create conflict over priorities, which can create “turf” wars. The approach focuses on departmental rather than firm issues and goals and tends to develop managers who are experts in narrow fields.

Place departmentalization

Place departmentalization is based on geographic area, and groups all functions for the area at one location under one manager. Often this approach is used in larger companies, and may supersede functional departmentalization — for example you may have several credit departments that report to a regional credit manager.

Advantages to the place approach are that managers develop expertise in solving problems unique to their location, and get to know their local customers’ problems very well.

A disadvantage to this method includes the fact that all functions (accounting, sales, production, etc.) are duplicated at each location. Another negative is that place departmentalization may require extensive rules and regulations to coordinate and ensure uniformity among locations.

Product departmentalization

Product departmentalization arranges your business along “product” lines, and is the approach best suited to the financial departmentalization discussed in more detail below.

Examples in the feed and grain business would be to organize the firm according to the departments of: feed, grain (including merchandising and storage), farm supply — which may be further broken into lines like agronomy (fertilizer and chemicals), and/or equipment.

Product departmentalization can allow for quicker changes in a product line, and can also provide for greater “product” line visibility within your firm, as the product is more clearly delineated, particularly from a profit and loss standpoint. This approach also tends to foster a

bit more concern for customer demand, as the impact of customer demand can more easily be traced to a particular department.

Taken to the extreme (usually in larger firms, not smaller ones), product departmentalization may not use skills and resources effectively, as they cannot be spread across the whole organization to take advantage of economies of scale. In addition, the approach does not foster coordination of activities across product lines and can limit career mobility for personnel outside of their product line.

Customer departmentalization

Finally, customer departmentalization breaks the organization into groups based on the type of customer served. It is used when management wants to ensure a focus on customers' needs rather than the organization's skills (functional approach) or the products it produces and sells (product approach).

This approach is frequently used in service organizations. However, an example in the feed business would be a department that focuses its efforts on what might be termed "commercial" livestock operations — those who are quite large and buy in volume and who desire specialized nutritional and management services.

There are some clear advantages to customer departmentalization, including greater customer focus; definitive identification of key customers; the fact that it is well suited to understanding customer needs; and that this approach develops managers who become customer advocates.

Some of the disadvantages of this approach are that employees may feel pressure from customers to give them special deals or privileges and that problem solving may be restricted to a single type of customer.

Breaking Your Business into Profit Centers

As mentioned above, departmentalizing your firm by product

group can allow you to analyze each product or service line as a profit center. So how is this done? Basically, track your revenue and expenses by each department that have been set up. In essence, you end up with a "mini" profit and loss statement for each department.

Typically, it is not very difficult to allocate revenue into departments such as grain, feed, farm

supplies or custom application — particularly when using a software package that allows you to assign a numeric code to each source of revenue. However, allocating resources — the buildings, equipment, and labor (both hourly and salaried employees) associated with each of the new departments — is much tougher.

You can allocate fixed assets by

estimating the percent of their value (and therefore depreciation) that should be allocated to each department. Then allocate labor by one of two ways — either by estimating or by a sampling of the time/effort spent in each “department.” The sampling can be accomplished by having your employees keep track of their efforts on a checklist for a period of

time — perhaps one day a week for a month, or something similar.

Why departmentalize?

Departmentalizing a business into profit centers allows you as the manager to view the firm in a different light, more than just looking at your monthly or quarterly Profit and Loss statement.

It delves deeper and shows which

product lines are most and which are least profitable. It can help you to better manage those lines that are not generating sufficient profit — either by increasing revenue generated in these departments by adjusting pricing or improving the bottom line by reducing expenses.

Or conversely, it can allow you to say — “We’ll accept less profit in this line, because it supports our other business.” The idea is that departmentalization can help you to put the picture into a more clearly defined perspective.

In brief answer to the query we raised in the introduction to this column — do some of your departments subsidize others, and if so, does it matter as long as your overall business is profitable? We would argue that the answer to this question is probably no. It doesn’t matter if some product lines or services are less profitable than your overall firm average or even unprofitable as shown by departmentalizing your business - as long as your company is generating an overall profit.

However, scrutinizing your business by department allows you to make a conscious decision to let this happen, and to see the potential impact. And perhaps viewed in this light, there may be ways that you can recover some of the costs that are contributing to this lower profitability — if it is occurring.

A final thought regarding setting up profit centers by department is that this approach is not just for large firms. Smaller firms can benefit from the insight that it provides management as well.

Think of departmentalization as an additional tool that allows you to view your business from a different perspective. 

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