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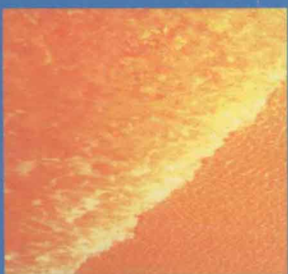

Management Accounting for Hospitality and Tourism

THIRD EDITION

Richard Kotas

INTERNATIONAL
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BUSINESS PRESS

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Series editors' foreword

The International Thomson Business Press Series in Tourism and Hospitality Management is dedicated to the publication of high quality textbooks and other volumes that will be of benefit to those engaged in tourism, hotel and hospitality education, especially at degree and postgraduate level. The Series is based on core textbooks in key areas of the curriculum. All the authors in the series are experts in their own fields, actively engaged in teaching, research and consultancy in tourism and hospitality. Each book comprises an authoritative blend of subject-relevant theoretical considerations and practical applications. Furthermore, a unique quality of the series is that it is student oriented, offering accessible texts that take account of the realities of administration, management and operations in tourism and hospitality contexts, being constructively critical without losing sight of the overall goal of providing clear accounts of essential concepts, issues and techniques.

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The tourism and hospitality industries are diverse and dynamic industries and it is the intention of the editors to reflect this diversity and dynamism by publishing quality texts that enhance topical subjects without losing sight of enduring themes. The Series Editors and Consultant are grateful to Steven Reed of International Thomson Business Press for his commitment, expertise and support of this philosophy.

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Preface

It is now more than twelve years since the publication of the second edition in 1986. The present, third, edition has retained the basic structure of the book, but a number of significant alterations to the text have been made. Chapter 8 has been enlarged considerably by a new section on yield management and a full treatment of menu engineering. The two chapters 'Food cost control' and 'Beverage cost control' have been combined into a single chapter entitled 'Food and beverage control'. We have two new chapters. Chapter 11, 'Responsibility accounting', deals with the applications of responsibility accounting in hospitality. Chapter 20, 'Uniform system of accounts for the lodging industry', gives an outline of the ninth edition of the uniform system which is now well established throughout the international hospitality industry.

During the last decade or so many universities have introduced degree courses in tourism. The scope of the book has, therefore, been extended to cover tour operators, travel agents and other types of operation in tourism. It is hoped that *Management Accounting for Hospitality and Tourism* will appeal to an even wider academic audience as well as to practitioners in the hospitality and tourism industry. I am grateful to Kevin Collins of Thames Valley University and Michael Conlan of Bournemouth University who have, between them, read almost the entire manuscript and offered valuable comments.

London, 1998 Richard Kotas

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Orientation 1

INTRODUCTION

The last few decades have been characterized by unparalleled change. Information technology (IT) was still in its infancy some twenty years ago; and it is now having an immense impact on all of us as private individuals and on all business enterprises. Accounting and control systems throughout industry and commerce have, as a result, undergone a drastic change. Disposable incomes have generally shown a substantial upward trend—with obvious implications for eating out and international travel. The number of eating-out establishments has multiplied and travelling abroad for business and pleasure is now a fairly routine, commonplace occurrence.

There has also been, throughout Western Europe, a dramatic change in the structure of industry. Many of the traditional industries which used to be important employers of labour (agriculture, mining, shipbuilding, etc.) have declined very considerably. Other industries—and hospitality and tourism in particular—have established themselves as large, dynamic industries, and offer new and interesting careers to vast numbers of individuals. The hospitality and tourism industry—hotels, motels, restaurants, cafés, public houses, country clubs, leisure centres, tour operators, travel agents—now employs over 2.5 million people and is generally regarded as one of the UK's largest industries. Thus, from humble beginnings in the post-war years, the hospitality and tourism industry has become a substantial employer of labour, offering interesting and profitable opportunities to people with determination and imagination.

Even a brief examination of the nature of the hospitality and tourism industry will indicate that it is in many respects unique and different from other industries. Let us, therefore, now examine the major features of the industry, its main problems and the implications they have for accounting and control methods.

SALES INSTABILITY

Sales instability is a special characteristic and is inherent in almost all hospitality operations. Fluctuations which occur in the volume of business are of three kinds.

First, there is the annual pattern. Many hotels, restaurants and other establishments are seasonal, and whilst the degree of sales instability varies from one establishment to another, seasonality is generally regarded in the industry as a serious problem. Frequently, the volume of business achieved during the season is three times that in the off-season.

Secondly, we have the weekly pattern. Many city restaurants do little business during the first few days of the week, but operate at almost full capacity towards the end of the week. Numerous hotels both in London and the provinces find that the highest occupancies are achieved from Monday to Thursday, and the weekend is for them the least busy period of the working week.

Finally, to look at catering operations, there are fluctuations in the level of activity and the revenue inflow during the working day. Generally, peak periods are lunchtime and after 1800 hours. Thus, whatever the nature of the establishment, there are continuous changes in the volume of sales—daily, weekly and annually.

As far as tourism is concerned sales instability is also very much in evidence, and this is true both in relation to British holiday-makers travelling abroad and foreign tourists arriving in the UK. Most of the travel occurs during the summer months and has a most significant impact on hotel and restaurant occupancies and demand for public transport and various places of interest.

The effect of sales instability is to produce three problems. First, there is a degree of uncertainty about the future volume of sales. Secondly, where there is sales instability there is inevitably some spare capacity and the consequent failure to utilize fully the resources and facilities of the establishment. Spare capacity, coupled with a high level of fixed costs, tends, in turn, to result in a high degree of profit instability. During slack periods considerable losses may be incurred and these may take quite some time to recover during busy periods.

The implications of sales instability for accounting and control procedures are quite clear. As there is uncertainty about future revenue inflow, we must develop appropriate methods of prediction. In relation to food operations this means the maintenance of a well-developed system of volume forecasting. In relation to room sales it means the use of occupancy statistics to predict future occupancy levels with a fair degree of accuracy.

Secondly, it is necessary to adjust operating cost levels to the ever-changing volume of sales. Food costs will automatically be adjusted where there is a system of volume forecasting. Efforts must, therefore, be made to control labour costs and other non-fixed expenses to ensure that they stand in the correct relationship to the current volume of sales.

Thirdly, in order to cope with the problem of spare capacity it is essential to evolve an effective and often sophisticated approach to pricing. The pricing policy of the establishment must not only give it the fullest benefit of high occupancies in the peak-periods. Where demand in the peak-periods is more than can be accommodated by the establishment, the price structure must be such as to shift demand from peak to off-peak periods and thus ensure an increase in the overall volume of business.

During the last decade or so hotel operators have begun to appreciate more fully the implications of seasonality and sales instability for the profitability of the establishment. They have decided that as demand for hotel accommodation changes from one month/week/day to another—and the number of rooms remains constant—this must have a direct impact on room prices. The pricing system that has in consequence emerged is eminently demand-oriented, and is now known as 'yield management'. We consider the operation of yield management in Chapter 8. Prices charged by tour operators are equally sensitive to demand. A given holiday costing, say, £800 in the height of the season will frequently be offered for less than £500 during the low season. Finally, readers who travel by rail will, no doubt, have noticed that the price paid for a given journey will vary depending on the day of the week and indeed the time of the day. Thus throughout the field of hospitality and tourism we see a pricing system which is complex, sophisticated and invariably demand-oriented; we see a pricing system that is, essentially, conditioned by seasonality and spare capacity.

COST STRUCTURE

Most hospitality establishments have a high proportion of fixed costs, and this applies particularly to hotels and other residential establishments. Considered from the point of view of the various revenue-producing departments, the position is this. Overall approximately three-quarters of the total cost of a hotel is fixed and uncontrollable. The relative proportions of fixed and variable costs will, however, vary from one department to another. In the rooms department we see a very high level of fixed costs, though in most cases such fixed costs are not apportioned to the rooms department but treated as (common) costs of the hotel as a whole. Variable costs such as laundry, linen and guest supplies constitute a very small percentage of departmental revenue—frequently less than 5 per cent. Departmental payroll is usually a semi-fixed cost.

Hotel food and beverage operations incur a considerably higher level of fixed costs, and this consists mainly of wages and salaries in the kitchens, dining rooms, bars, etc. Also the level of variable costs—essentially food and beverage costs—is considerably higher than in the rooms department.

Restaurants have considerably lower fixed costs—in many cases 40–50 per cent of total sales. Their variable costs tend to average 40–45 per cent of total sales volume.

Tour operators are, in this respect, similar to hotels, and also operate at a high percentage of fixed costs. Costs such as salaries and wages of head-office staff, rents, rates, etc. tend to be fixed and quite unaffected by current sales volumes. Salaries paid to couriers/guides and company representatives in the relevant destinations are also essentially fixed, though some of the employees would only be engaged during the high season. Finally the cost of air transport, hotel accommodation and excursions also tends to be fixed in that the tour operator has to purchase a fixed amount of such services and pay for them regardless of actual take-up.

Retail travel agents act on behalf of tour operators and other principals (railway companies, coach operators, etc.). Their remuneration tends to be based on a fixed percentage of sales—frequently in the region of 10 per cent. Some additional revenue is secured from the sale of foreign currency and insurance policies. The most important operating costs of a travel agent are staff costs and the rent paid for the premises. Most travel agents are situated in prime high-street locations where rents are high.

Mention has already been made of the effects of sales instability. The combined effect of a high percentage of fixed costs, fluctuations in the sales volume, and spare capacity is to produce a condition of profit instability which is quite uncommon in many other industries. The higher the percentage of fixed costs the more difficult it is to maintain adequate profitability through cost manipulation. In such circumstances, whilst paying adequate attention to cost control, one should be more concerned with the control of the revenue of the business. The main implication of the high fixed-cost structure of the business unit is that the traditional cost-oriented approach to accounting and control problems is only partly relevant. Cost analysis, cost control, cost statements, etc., are not the right weapons with which to attack obstacles to hospitality and tourism profitability. We must, instead, look at the other side of the profit and loss account and look for solutions in the total sales volume, sales mix, departmental profit margins, occupancy rates, pricing devices, etc.

NATURE OF 'PRODUCT'

The nature of the product sold by an industry is of considerable importance for a number of reasons. A product which is durable may be stored for long periods and held in large quantities to meet peaks of consumer demand. During inflationary periods there is often the added advantage of selling at an increased price a product which was manufactured some months previously at a relatively low cost.

The product of the hospitality industry is entirely different. A hotel bedroom which has not been sold is an irretrievable loss. Similarly, food is perishable both in raw material form and as a prepared meal.

With regard to accommodation the solution to the problem of product perishability requires a dual approach. First, we must have adequate predictions of hotel occupancy levels which, by definition, will indicate what spare capacity will obtain over a future period. Secondly, we must ensure imaginative pricing and effective marketing: price concessions, off-season rates, mini-weekends, conferences and business meetings all have a great contribution to make. The management accountant, though not a marketing expert, certainly has an important part to play in this context.

Finally, hospitality establishments do not sell a single product, but a multiplicity of mainly low-priced items. Whatever the wisdom of it, many restaurants have menus containing well over one hundred items, each of which has to be separately costed, prepared, served and accounted for on the customer's bill. In the case of hotels there is an even greater multiplicity of products and services offered to the customer. To quote from a well-known American text

(E. B. Horwath, L. Troth and J. D. Lesure, *Hotel Accounting*, New York: Ronald Press, 1963, p. 9):

> There is hardly any other business in which the amount involved in each individual transaction is so small and where these transactions, cash or credit, follow each other with such rapidity. A guest may arrive and take a room, have his baggage delivered, use the telephone and valet service, have his meal in his room or in the dining room, send a telegram, purchase cigars and dictate a few letters to the public stenographer, all within little more than an hour. During the same time he must be registered; his name must be listed so that mail and telephone calls can reach him; an account must be opened for him; the baggage porter, telephone operator, valet, restaurant cashier, telegraph office, cigar stand and the public stenographer must all record the charges for their services, and must report the charges to the bill clerk, who, in turn, must post them to the guest's account.

Of course, all the postings to the guest's account must be made as soon as possible so that his bill may, if necessary, be ready for presentation virtually within minutes. There must be few other industries where the speed of sales recording and an efficient cash collection system are so important.

The tourist product is an amalgam of elements such as transport, hotel accommodation, food and drink as well as the facilities available and the characteristics of a given destination. It is somewhat similar to the hotel meal in that it consists of a number of different components. It is, importantly, also similar to the hotel room in that it is highly perishable. As far as the tourist product is concerned, therefore, tour operators are in the same situation as hotels. A holiday package that remains unsold cannot be stored and sold subsequently: it is an irretrievable loss.

CYCLE OF OPERATIONS

In some industries the time taken from the purchase of raw materials to the sale of the finished product is long, sometimes a matter of months. In hospitality establishments the cycle of operations is, on the other hand, very short. Food delivered early in the morning is often processed later that morning and sold the same day.

Unless there are adequate checks and control devices at each stage of the catering cycle it will be very difficult for the establishment to reach an acceptable level of profit. The checks and control devices must be such as to cover the whole of the catering cycle, i.e. (a) buying, (b) receiving, (c) storing and issuing, (d) food preparation, and (e) selling.

In addition to adequate and comprehensive controls of both revenue and operating costs, each establishment needs a reporting system related to this particular cycle of operations. There must, therefore, be relatively more short-term reporting than is the case in other industries. It will be found that most well-managed establishments have a variety of daily and weekly reports in addition to monthly and quarterly operating statements.

As far as tour operators are concerned, the cycle of operations is quite different. Holidays planned for any given period must be arranged at least a year in advance, resulting in a fairly long cycle of operations. It should be noted, however, that, unlike in manufacturing industries, this long cycle of operations does not necessitate the holding of large stocks of materials over long periods.

The retail travel agent sells services made available by tour operators and other principals. The sale of a holiday or train ticket requires no previous arrangements to make these services available. The cycle of operations is, in such circumstances, practically non-existent.

Business orientation

In the first half of this chapter we have stressed several times that the two most powerful factors which militate against hospitality profitability are sales instability and high fixed costs. It is, in fact, the stability or otherwise of demand and cost structure that jointly determine what may be described as business orientation.

When one considers the various sectors of the hospitality industry, one can distinguish two types of operation. Some establishments operate at low fixed costs and enjoy a relatively stable volume of business. Others have a high percentage of fixed costs and are subject to a high degree of sales instability. In the first category we have various kinds of welfare catering: industrial canteens, hospital catering, school meals, university and college catering, etc. In the second category we have hotels, motels, guest houses and similar operations. The two groups of establishments, though integral parts of the industry, are so different in many respects that it is useful to be able to summarize such differences by attaching to each group a different label. For our purposes here we will refer to the first group as 'cost-oriented' and to the second as 'market-oriented'.

Of course, where there is a broad classification such as the one suggested above, it is inevitable that there should be borderline cases, i.e. types of operation which are partly cost- and partly market-oriented. It is thought nevertheless that the two labels are valuable and may serve many useful purposes.

In order to determine the degree of cost or market orientation of a business we may use a *business orientation chart*. This measures, vertically, the respective proportions of fixed and variable costs and, horizontally, the stability or otherwise of consumer demand. Having drawn the two axes, we may show the positioning of any one type of hospitality operation and thus decide to what extent it is cost- or market-oriented. From Figure 1.1 it will be seen that the most market-oriented establishments are positioned in the top right-hand area, and those most cost-oriented in the bottom left-hand area of the chart.

From the figure it would appear that the most market-oriented types of business unit are hotels (H) and tour operators (TO). On the other hand, canteens (C) and university catering (UC) tend to be essentially cost-oriented. It is possible to argue about the exact positioning of any one type of business. What, however, matters here is the general principle. It is difficult to plot