4 Managing costs

- Types of costs
- Ratios
- Control of costs
- Raw materials
- Labour
- Other costs

Introduction

In the previous chapter we discussed revenue and identified a range of areas where it can be improved by either sales or control techniques. However, in reality there may be only limited opportunities for you to improve revenues, or you may not have them at all. You then need to look at the other side of the P&L – costs. Controlling costs has always been more popular than controlling revenue with potentially large savings to be made by the manager, or so says the traditional view of the accountant.

In this chapter we'll look at the principles of controlling costs but within the constraints of maintaining the quality of customer service and product – which if not managed would result in an adverse effect on revenues. To do this we need to understand how costs behave, some being more controllable than others. You need to concentrate on managing what is manageable. As with revenue we'll also review the relevant ratios that will help indicate problems and then look at a range of techniques to minimise costs.

By the end of this chapter you will be able to:

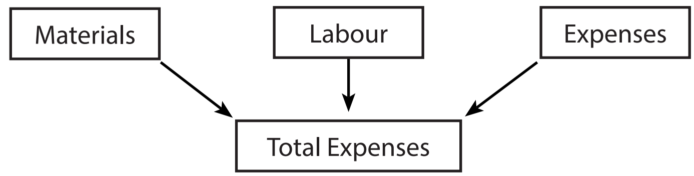
- Identify the types of costs that occur in the various hospitality sectors
- Define cost behaviour and the difference between fixed and variable costs
- Calculate cost ratios
- Extract the fixed and variable elements from a series of total costs.

Types of costs

Many sectors rely on the effective control of costs in order to optimise the 'bottom line'. Managers can take simple actions which will have a significant effect on some of the costs, but other costs are relatively unmanageable. Hence, in order to target our attention and activities, we need to know which are *controllable*, and which are not. First, let's see the three main types of costs which are raw materials, labour and everything else (see Figure 4.1). We mentioned these in Chapter 2 when we looked at the P&L report. The 'everything else' can be split into departmental expenses, administrative expenses and property costs such as rent, rates and so on.

This type of classification doesn't really help us very much to manage costs because it doesn't tell you which you can control and which you can't (with the exception of the Fixed Charges below the GOP line, mentioned earlier). To really understand, we need to re-classify costs into how they behave.

Figure 4.1:
Types of costs



Costs can be *fixed*, *variable* or *semi-variable* (the terms 'mixed' or 'semi-fixed' are used in some textbooks).

Variable costs

Costs that are *variable* are totally dependent on the volume of sales. If you sell something then you incur a cost – so if you sell a bottle of cola you'll have the cost of that bottle. The raw materials that make food and beverage (the cost of sales, in other words) are the main type of variable cost but there are lots of other examples such as napkins, packaging for fast food, gift packs for guests, paper for printing tickets or guest bills. Some labour costs may be variable where you only employ staff if they have people to serve – banqueting is the most common example although takeaways try to operate on variable labour too.

These are relatively easy to manage as you shouldn't have a cost if there hasn't been a sale, but you do need to keep track of them to make sure things (such as bottles of cola) aren't going missing.

Fixed costs

Fixed costs, however, aren't affected by the volume of sales and so don't change much during the year. Typical examples are the fixed charges ('overheads' – rates, depreciation, and so on) already mentioned, but also departmental and administrative costs, such as staff and management salaries, hire of equipment or flowers. It is difficult to manage these as you need them, no matter what the level of business, in order to maintain quality.

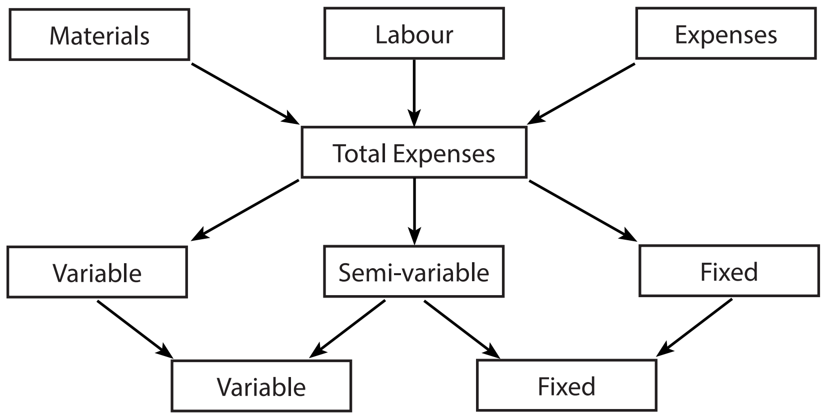
Obviously if a staff member leaves then you can think about when or if you will recruit a replacement, but that's the only time you can easily reduce this cost (you wouldn't like it if your boss suddenly decided not to pay you if there wasn't enough business, would you?). Although making staff redundant may be an option, this can be expensive and time-consuming, as well as affecting the morale of all staff.

Semi-variable costs

Some costs are a mixture of fixed and variable and are called semi-variable – and so some parts are controllable and other parts aren't. For example, if you have a guest house then you need to have the lights on all the time in the entrance hall (fixed) but a bedroom light is only on when the room is occupied (variable). Another common example is staff pay – their basic wage is fixed but any overtime worked is variable.

Figure 4.2 extends the diagram in Figure 4.1.

Figure 4.2: Types of costs



Other words you may hear quoted are 'direct' and 'indirect'. Direct costs are those able to be charged straight to a department. Indirect costs are generally those that belong to the property as a whole (including administration costs).

Different types of business

The disparate sectors all have these types but in varying proportions depending on how they operate – and so have different levels of controllability. In general, the higher priced the product is, the more likely the business is to have greater fixed than variable costs. This is because they tend to have a higher number of permanent well-trained (fixed) staff and also standard expenses (flowers and music all the time, for instance). Lower priced sectors, such as takeaways, are more likely to have variable paper goods or labour (part-time and with limited skills).

It may also be the particular location that affects the cost behaviour. If you have a remote site (an island, oil rig or middle of the desert, for instance) you often have to transport almost everything in, including the staff and all supplies. In these scenarios costs that might normally be variable can become semi-variable or fixed.