5 Practical cost behaviour for decisions: dropping a stone into water

Developing profitable business

Managers are constantly making routine, day-to-day, operating decisions that affect revenue, cost and profit. Daily decisions may involve relatively modest transactions, but when multiplied and accumulated over the financial year can have a serious impact on bottom-line profits of business undertakings. Examples of such decisions made by hospitality and tourism property management teams include:

- Negotiating new business, such as cocktail receptions, banquets & dinner dances, conferences & exhibitions, block room reservations, tours and visitor groups.
- Enhancing sales volume and business mix by growing particular department revenues, such as restaurant parties and hospitality events, meeting rooms and school study visits, or emphasising potential market segments, e.g. corporate, tour or leisure groups within the customer mix.
- Determining pricing policies involving annual & seasonal price structures, pricing special promotions and *ad hoc* competitive bids.

Creating new opportunities whilst nurturing and extending current business in a competitive environment is essential if an undertaking is to remain viable into the future. However, driving revenue, in itself, is not enough and here lies the problem! If, for example, we pursue business deals offering great, give-away, prices to boost sales volume and undercut competitors – with no real grip on the cost or margin implications – we are in danger of eroding profits and becoming busy fools, potentially working more and more for less and less financial reward!

Creating a profit planning framework

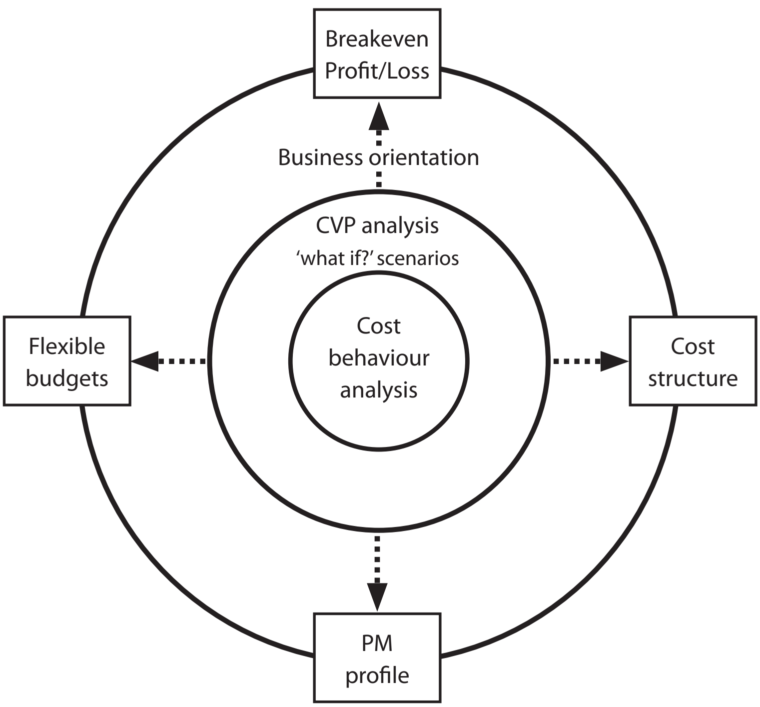
Whilst it's crucial to understand the marketplace and know the strength of competition, it is equally important to have a sound grasp of the costs involved in operating a business. Engaging with our own operating costs will refocus attention away from simply driving revenue to growing and enhancing profitable revenue.

Managers are acutely aware of the various operating costs incurred in running their businesses, but are often less aware of how to use costs to advantage in making routine business decisions. However, if we are prepared to go the extra step of understanding how our own operating costs behave (change) in live, practical, situations this will provide two key benefits:

- ♦ Give new insights into the nature and operating characteristics of our properties in financial terms, through the eyes of revenue, cost and profit relationships
- ♦ Allow us to approach routine, day-to-day, business decisions with a new confidence, from a position of strength.

These are interesting and enticing thoughts, but how can they be achieved in the practical situation? Let's see how the approach can work in the live situation!

Profit Planning Framework
(Understanding your business financial dimension)



Applying marginal accounting techniques
(at the property level)

Figure 5.1: Profit Planning Framework

As implied by the comments above, we can learn more about our own business and enhance the quality of routine business decisions by revisiting our operating costs.

If we re-examine our profit and loss statement expenses in terms of cost behaviour, that is how costs change in response to changes in the level (volume) of business, we can establish which costs vary and which costs remain fixed.

Once we analyse our costs into fixed and variable behavioural groups, we can begin to see our business in a new light, as a complete entity with respect to the bigger picture and also in terms of routine, day-to-day, decision-making. The profit planning framework presented in Figure 5.1 illustrates this in diagrammatic form. So, let's see what it's all about.

'Dropping a stone into water'

Imagine dropping a stone into water. As the stone strikes water it causes a ripple effect by sending miniature waves out from the (central) point where the stone struck the surface. This is precisely what happens when we identify the fixed and variable expenses in our profit and loss statements – by classifying our costs into fixed and variable groups we are dropping a stone into water!

As illustrated in Figure 5.1 *Profit Planning Framework*, once we analyse our cost behaviour, we can immediately begin to benefit from the ripple effects by being able to apply practical CVP – cost-volume-profit analysis – techniques across a range of business issues to:

- Determine break-even, profit and loss scenarios for routine, day-to-day, profit planning decisions at the property level and develop new business revenue streams at the individual transaction level. (Explained and illustrated in Chapter 6.)
- Recognise the importance of connecting the operating cost structure to the nature of products and/or services in order to understand the orientation of a business and the approach to decision-making at the property level. (Explained and illustrated in Chapter 7.)
- Enable the use of flexible, adjustable, budgets for annual forecasting, annual and/or monthly budget preparation and budgetary control purposes. (Explained and illustrated in Chapter 8.)
- Determine the profit multiplier profile of business property operations to assist in developing profit improvement programmes. (Explained and illustrated in Chapter 9.)

Note: Applying cost behaviour and CVP analysis techniques can also provide greater insights into the general nature (business orientation) of our own particular business, which can help guide our approach to strategic decision-making at the property level.

Note: In Figure 5.1, in the phrase 'applying marginal accounting techniques (at the property level)', the term 'marginal' refers to the marginal or variable cost of producing one more product or serving one more customer.

Since cost behaviour – dropping a stone into water – is fundamental to the Profit Planning Framework let's understand how we approach the analysis of cost behaviour in business.

Practical analysis of cost behaviour

Practitioners often find the analysis of cost behaviour in the live situation – in their own business properties - quite challenging. However, much of modern business operations involve estimating future activities, such as customer numbers, business mix, changing consumer tastes and preparing budgets. Although rarely exactly on target, the process of projecting ahead provides a valuable basis to think through possible opportunities and, in doing so, anticipate potential limitations that test the robustness of our business scenarios.

Experience suggests that industry professionals contemplating the analysis of cost behaviour in their own properties are intuitively drawn by the appeal of the theory, but fear the results of the practical application. There appears to be a sense that, if the analysis of costs is not accurate or precise, all subsequent decisions will undermine the business. The sentiment is understandable, but the rationale is misguided on two counts:

- Whilst early attempts at cost behaviour analysis will be tentative, managers will become more aware of the nature of their business expenses and refine estimates of fixed and variable cost assessments accordingly.
- By engaging with relevant costs associated with business transactions – where lost margins often lie – managers are encouraged to generate profitable revenue rather than solely driving sales volume.

The purpose here is to explain the process of cost analysis, based on judgement and experience drawn from operating a business. For a step-by-step quantitative analysis of cost functions refer to the Appendix, p.229.

Note: The important point to remember when analysing expenses is not to over-complicate the procedure in order to give an impression of exactness. Whatever the form of cost analysis used in the live situation, precision is an illusion. Keep in mind, the analysis should be as accurate as possible, but simple to use.

A practical analysis of operating cost behaviour for a business property requires transposing the traditional (departmental) profit and loss statement (comprising direct and indirect costs – explained and illustrated in Chapter 2) into a marginal profit and loss statement containing fixed and variable costs.