12 Developing customer profitability analysis

Customer profitability analysis provides the means to analyse business operations, and especially an undertaking's profitability. Here we explain the approach to measuring customer profitability in the context of a hotel property, placing particular emphasis on the customer contribution to profit and the distribution of profits among the hotel customers.

By using customer profitability analysis, hotel companies can determine the profit contribution of customer segments (groups) or, in some cases, even individual customers.

What is customer profitability analysis?

Customer profitability analysis provides insights concerning customer demand and how customer value can be created, and is particularly appropriate in hotels operating in highly competitive markets. It is vital for hotel managers to understand the set of hotel attributes which are demanded by the potential customer. For example, hotels with a strong market orientation will tend to:

- Attach a relatively high degree of importance to the acquisition of customer related information.
- Incur considerable discretionary marketing costs in areas such as customer support.

Marketing planning in hotels usually focuses on customer market segments, with specific marketing activities and packages being directed towards individual market segments, for example, business, leisure or conference segments. The marketing plan also generally shows the marketing activities planned according to the identified market segments.

Although the Uniform System of Accounts for Lodging Industry (USALI) provides the basis for recording, controlling and benchmarking the hotel departments, i.e. rooms, food and beverage, and minor operating departments, it is not designed to determine the planning and optimising of the customer mix, i.e. market segment and customer profitability. As a result, accountants are producing information based on departments, while managers are making decisions based on market segments, thus creating a mismatch between the provision and use of routine information at the hotel property level.

Customer profitability analysis involves the identification of revenues, costs and profit by individual customer or customer segment (group). Although product costing is important for the purposes of departmental (functional) reporting and in assisting management with controlling and planning product mix, customer profitability analysis can enhance the customer mix decision-making. We can describe customer profitability as follows:

Revenue per customer – cost per customer = customer profit contribution

Customer profitability is the difference between customer revenues earned and the costs associated with the customer during a specific period.

Customer profitability analysis and revenue (yield) management

Revenue management has received considerable recognition from industry professionals as an effective technique for evaluating sales and pricing alternatives in capacity management decisions. Demand forecasting and revenue projections are used to evaluate sales alternatives in terms of revenue maximisation. Hotels attempt to achieve the mix of customer segments that optimizes room occupancy and average room rate. Revenue maximisation is generally considered to be an attractive goal, because it increases the amount of money flowing from existing demand.

Market demand pricing is an appropriate short-term strategy, but to remain profitable in the long run, hotels must achieve an average rate that covers both fixed and variable costs. Customer profitability analysis can be seen as an extension to the traditional revenue (yield) management model that focuses on achieving an optimal balance between the quest for high room rates and the quest for high occupancy by providing the assessment of costs incurred to support the sales of each market segment.

By combining both revenue and cost data, customer profitability analysis provides management with important information regarding the customer base which is essential if well-informed decisions are to be made in the longer-term. Customer profitability analysis empowers management response to volatile market conditions and enhances the revenue yield process.

Understanding activity-based costing

The Uniform Accounting System for the Lodging Industry is a traditional accounting system that concentrates on departmental costing in which each department is a profit or cost centre. Departmental costing gives good visibility to expenditures and allows them to be budgeted and controlled by departmental heads. Such costing is of great value in helping to manage service costs and in providing managers with relevant unit costs of products. However, when the focus of interest is customer profitability, a different approach is needed.

The implementation of customer profitability analysis within a hotel property requires a modification of current accounting approaches towards revenue and cost allocation. This requires the identification of revenues and expenses which are traditionally recorded by operating and service departments to be reallocated to customer groups. Figure 12.1 illustrates the distribution of revenue and costs are traditionally recorded in accounting systems to recording costs by customer group.

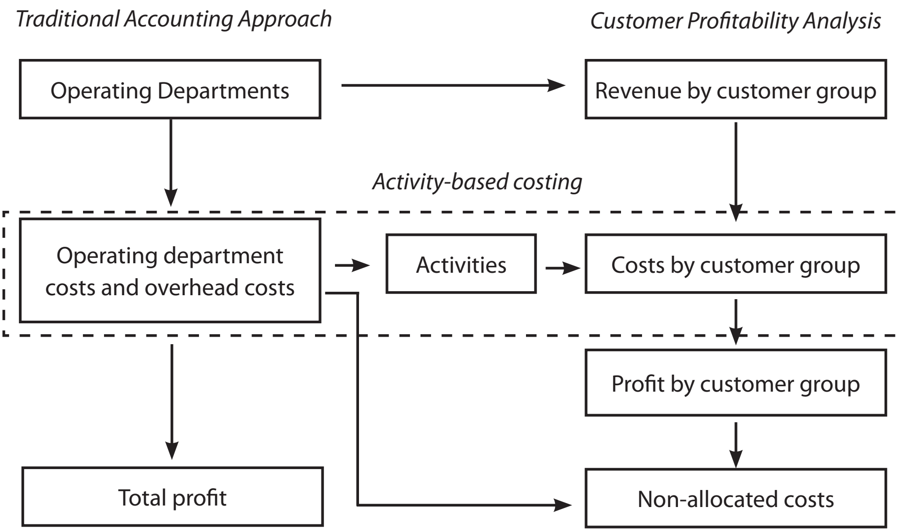

Figure 12.1: Distribution of revenue, costs and profits[1]

Activity-based costing is the technique used to allocate operational direct costs and indirect costs (overhead) to activities. Activities represent functional costs of providing services to customers and support of the sales effort to each market segment, such as room, restaurant, accounting, human resources, marketing and administration. According to the conventions of customer profitability analysis, the small number of costs for which reasonable cause and effect relationship with customers cannot be found should not be allocated. These expenses should be covered by a hotel's overall operations margin.

Activity-based costing process at the property level

Activity-based costing involves distributing routine operating costs incurred in business operations, incorporating the following elements:

- Profit centre and service centre costs are allocated to activities.
- Activities consume resources from the profit and cost centres.
- Activity costs are allocated to cost objects (customers).