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Managing costs

About this chapter

The effective management of operational business costs is a major challenge for any organisation. In the hospitality, tourism and leisure industries it is particularly crucial as margins are often low for each sale, with the business dependent on achieving high volumes of transactions. The benefits are obvious in that a reduction in operational costs will lead to an increase in the profits and the profit to sales ratio (profit margins), and an improved return on capital employed. Yet for many organisations the need for cost controls is only highlighted when costs have already started spiraling out of control, or when revenue levels are falling during periods of intense competition or recession. This chapter considers first how routine performance can be monitored and controlled and then provides suggestions for a longer-term approach to strategic cost reduction with the purpose of improving a business's opportunity for competitive advantage. The specific aspects to be covered are:

- The nature of costs
- Costs for decision making
- Monitoring routine performance
- Investigating the cost base
- Cost leadership
- Competitive analysis
- Porter's approach to competitive advantage.

Learning objectives

On completion of this chapter, you should be able to:

- Understand the meaning of different classifications of cost
 - Understand how to classify costs into different categories and apply techniques for determining the nature of costs
 - Construct break-even, contribution and profit volume graphs
 - Apply cost-volume-profit analysis to varying sales mix situations
 - Understand how a knowledge of cost structure facilitates competitive advantage.
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Introduction

Costs can be classified in different ways depending on the source of the information and also on how the cost information is to be used (Table 4.1). Essentially all cost information can be used for control and planning purposes as follows:

- ❑ **Control purposes** where costs are being matched to revenue to establish profitability for an area, product or market
- ❑ **Planning purposes** where information about costs is used to set pricing strategies, monitor profit margin and manage sales-mix profitability.

Basic cost elements	Direct and indirect	Fixed and variable
<i>Materials</i> Including food and beverage costs	<i>Direct</i> Materials Salaries and wages Expenses	<i>Variable costs</i> Costs which vary linearly with the volume of products and services sold
<i>Salaries and wages</i> Costs associated with the employment of the permanent and contracted staff	<i>Indirect</i> Materials Salaries and wages Expenses	<i>Semi-variable</i> Costs which contain a variable element and a fixed element
<i>Expenses</i> Operating and overhead		<i>Fixed costs</i> Costs which remain constant regardless of the level of business activity over a 'relevant range' of activity

Table 4.1: Alternative approaches for the classification of costs

The basic cost element approach represents the simplest methodology for classifying costs, based on an analysis of the resources required to produce the product or service. There are three types of costs found in operations:

1. **Materials** represent the cost of the components that make up the product – for example a restaurant meal or drinks cocktail.
2. **Labour** includes all the wage, salary and related costs associated with rewarding the workforce for their efforts, including uniforms and pensions as well as salary costs.
3. **Expenses** includes all other operating and overhead costs

This approach forms the basis of the sequence of the basic profit and loss account.

A second approach is to divide costs into those which can be assigned to products, services, departments or particular activities, i.e. *direct* costs, and those which cannot be assigned, i.e. *indirect or overhead* costs. The hospitality industry overhead costs are often known as '*undistributed operating expenses*'. Examples of direct costs include the basic cost elements, but this time these costs are directly attributable to a specific area of the business:

- ❑ **Materials:** cost of sales, e.g. ingredients
- ❑ **Labour:** restaurant manager's salary
- ❑ **Expenses:** laundry of table linen.