6 Costing, Pricing and Capital in the Events Industry

In this chapter you will cover:

- Classification of costs
- Traditional cost accounting concepts
- Marginal costing
- Absorption costing
- Contract costing
- Event costing
- The structure of a contract
- Break-even analysis
- The role of capital investment decisions
- Investment appraisal methods used in businesses

This chapter will examine the accounting methods a company uses for its internal reporting and decision-making, in order to give event managers sufficient financial knowledge to manage the company. One of the most important aspects of management accounting is to provide the managers and board of directors of companies with information related to its costing. The reason why costing information is important is that it helps managers to understand and know what selling price would lead to a profit. The chapter will also explore the relationship between profit and investment expressed through a measure referred to as capital investment appraisal. Capital investment appraisal methods consider the rate of return, and they therefore overcome the main weakness of cost-oriented methods by focusing on profit and taking account of the investment necessary to generate that profit.

Classification of costs

Management accounting is a management information system for analysing past, present and future data for decision-making. Cost accounting is defined by the Chartered Institute of Management Accountants (CIMA) as:

that part of management accounting which establishes budgets and standard costs and actual costs of operations, processes, departments or products and the analysis of variances profitability or dual use of funds. (Association of Accounting Technicians, 1990: 3)

Traditionally, the elements of costing for events organisations are classified as shown in Figure 6.1.

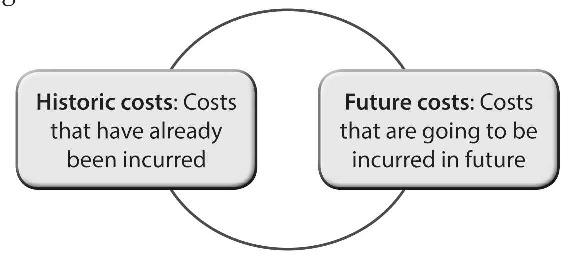

Figure 6.1: Traditional costing concept for events

The organisation incurs a number of different costs when it produces goods or in carrying out a service. Under the cost accounting system these costs need to be split in various ways. One way is to split them into fixed costs and variable costs as highlighted in Figure 6.2.

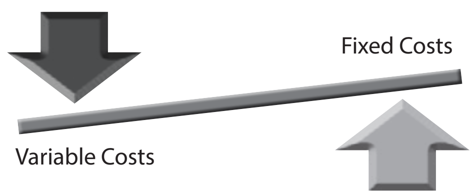

Figure 6.2: Fixed and variable costs

■ Fixed costs

Fixed costs are not related to products or services, but are totally independent of the company's output. Fixed costs remain fixed for a period and are unaffected by increases or decreases in the level of activity produced by the company. They only change with the time span; as the span increases, the fixed costs increase too. By keeping fixed costs under control, the business can enjoy a very healthy profit and achieve successful development in the future.

The most common fixed costs include:

- ☐ Business rates paid to the local authority
- ☐ Interest on bank loans
- ☐ Rent for the use of buildings or venues
- ☐ Staff costs for permanent members of staff
- ☐ Company liability insurance.

■ Variable costs

Variable costs change with the level of activity carried out by the organisation, and so they will change with the size and type of event. By controlling the variable costs the organisation can create more effective and efficient products or services. It is important for event organisations to bear in mind that the larger the event or festival, the larger the variable costs will be.

The most common variable costs include:

- Hiring the venue
- Printing of marketing material
- Advertising
- Guest speakers
- Weekly wages paid to the staff working on the event
- Gas and electricity bills.

Managers need to bear one important element in mind regarding fixed and variable costs. The clear difference between fixed and variable costs lies in whether the costs incurred will rise as the level of activity increases during the period of the event, or whether the costs remain the same during the event, regardless of the level of activity.

Traditional cost accounting concepts

It is important for managers to analyse and classify costs according to the purpose for which each cost is being used. The following are the most common cost concepts management accountants and costing managers are concerned with:

- **Total cost**: the sum of all items of expense which have been incurred in the process of the event or festival or in providing services to customers.
- **Standard cost**: the target or budgeted cost predetermined by the management or business prior to starting the event. The standard cost is estimated by the management in advance and then it is compared to the actual costs incurred during the event or activity.
- **Marginal cost**: determined by the level of activity. The fixed cost under this concept is considered separately.
- **Direct cost**: the cost which is directly related to the specific event or service. The direct cost is easily traceable within the event cost. For example, direct costs would include staff working on the event, security, equipment hiring and advertising for the event.
- **Indirect cost**: the opposite of direct costs. Indirect expenses cannot be traced to the finished product or event. These are costs which are incurred in the business or for the event from its start to its finish. They may include office expenses which are not related to the event. For example, salaries of company directors, rent, rates and insurance for the whole year cannot be directly related to one particular event.

- **Functional cost**: the cost which relates to a specific event or festival. It is the cost that is attached to an area of operations in a business such as security, administration, marketing, personnel or development.
- **Controllable and uncontrollable costs**: this accounting method provides management with clear guidelines in advance as to which costs are controllable and which costs are not controllable by management action.
- **Incremental cost**: this is incurred only when the individual event or project is undertaken. The incremental costs include both additional fixed costs and variable costs arising from the individual event or festival, besides standard costs that are already being incurred by the business.

Marginal costing

In the marginal costing concept, only variable costs are charged as the cost of sales and the contribution is calculated by accountants. They ignore fixed costs and overheads. Under marginal costing, fixed costs are treated as period costs and fully charged to the period in which they are incurred. CIMA defines marginal costing as:

[a] principle whereby variable costs are charged to cost units and fixed cost attributable to the relevant periods is written off in full against the contribution for that period. (Association of Accounting Technicians, 1990: 221)

It is impossible to calculate marginal costing without working out the contribution. The contribution is the difference between the revenue achieved during the event and the marginal cost of the event.

The contribution per event ticket can be defined as the selling price less variable costs. The total contribution can be calculated by businesses as shown below.

Contribution Per Ticket × Sales Volume = Total Contribution

Total Contribution Less Fixed Costs = Profit or Loss

Table 6.1 looks at operating statements set out in a marginal costing format. Notting Hill Carnival host annual events in London. Each has variable costs and fixed costs.

Notting Hill Carnival			
	Volume	Per ticket	Total
Sales	10,000	£50	£500,000
Variable costs	10,000	£30	£300,000
Contribution per ticket	10,000	£20	£200,000
Fixed costs			£75,000
Profit and loss			£125,000
Notting Hill Carnival's break-even point		£75,000	
		£20	3750

Table 6.1: Notting Hill Carnival operating statement, marginal costing format