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Finance for the Spa Industry

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Introduction

Many employees entering the spa industry, do so with a basic level of business knowledge and financial appreciation. As long ago as 2003, ISPA, in collaboration with the Association for Hospitality Financial and Technology Professionals, released the first edition of Uniform System of Financial Reporting for Spas. However, this is primarily focussed on accounting principles and the development of an internationally comparative accounting system. The current employment market reflects the spa industry's growing need for higher academic levels of business acumen which will enable the industry to fill the gaps in middle to upper management positions. The Global Spa and Wellness Summit report (2012) on addressing the market gaps on workforce and education, outlines the need for a mixture of soft and hard skills in future spa managers.

Financial appreciation is a key example of a hard skill that is rarely popular with potential employees, but always relevant for supervisory positions within the industry. Spa businesses range from independent day spas through to destination and resort spas. In some cases, they are separate business entities, while in others they are business units within a larger organisation and contribute to both the appeal and profitability of the overall business. Economic theory teaches that the purpose of business is maximising profit for the shareholders, a concept that was developed by economist Milton Friedman (1975) and despite more modern views on this matter adopting the corporate social responsibility concept, the profit maximisation requirement is rarely, if ever, lost completely.

This chapter examines the concept of profit maximisation within the spa context and identifies some of the basic tools available for its measurement and management.

Making and measuring profit

Businesses make profit by either selling something at a higher price than it was purchased or by providing a service for which a customer is willing to pay. The successful spa business does both of these, providing the service of spa treatments and offers retail products to spa guests. Assuming that prices for these services and products have been set appropriately, the business will make a profit for each treatment and sale made. In simple terms, *Profit equals Net Sales Revenue minus Costs of Goods Sold (COGS)*. So, if we sold a retail product for £20 (net sales revenue), that we paid £10 (COGS) to buy, we would make a £10 profit. Likewise, if a guest purchased a treatment for £45 (net sales revenue) with products used costing £7 (COGS), we would make a £38 profit. Profit calculated in this way is known as *Gross Profit* and it should be noted that these calculations are exclusive of any sales taxes, such as Value Added Tax (VAT) in the UK. Currently VAT is charged at 20% which would make the full retail price of the examples given above £24 and £54 respectively. Adding or subtracting sales tax is a relatively simple calculation. Using the current UK VAT rate, we can add sales tax using the following formula:

$$\text{Price Excluding Tax} \times (1 + \text{Tax Rate as a decimal}) \text{ or } £20 \times (1.2) = £24$$

To remove sales tax, again using the current UK rate, the formula is:

$$\text{Price Including Tax} \div (1 + \text{Tax Rate as a decimal}) \text{ or } £24 \div (1.2) = £20$$

Understanding *Gross Profit* is an important part of a manager's role as it allows them to understand what profit has been made over a given period, check this against what should have been made and compare potential profit scenarios using different products or volumes of sales. To do this, *Gross Profit* needs to be converted to a *Gross Profit Percentage* figure and the calculations for this are again very simple.

$$\text{Gross Profit} \div \text{Net Revenue} \times 100 = \text{Gross Profit Percentage}$$

Using the treatment example above, we identified that the *Gross Profit* was £38. Therefore, the *Gross Profit Percentage* would be:

$$38 \div 45 \times 100 = 84.4\%$$

For the retail product example, it would be:

$$10 \div 20 \times 100 = 50\%$$

The percentage figures above are often referred to as *theoretical* figures as they are calculated using theoretical information. For example, if a therapist performed twelve of the treatments identified above, the *Total Net Revenue* would be $12 \times £45 = £540$, the *COGS* would be $12 \times £7 = £84$ and would result in a *theoretical Gross Profit* of $£540 - £84 = £456$. If, however, at the end of the therapist's shift the calculation of the *COGS* (*value of opening stock + any additional stock provided during the shift - value of closing stock*) revealed that there had been additional product used to the value of £1 per treatment, the *COGS* would now be $12 \times £8 = £96$, the *actual*

Gross Profit would be $£540 - £96 = £444$ and the actual Gross Profit percentage $£444 \div £540 \times 100 = 82.2\%$. The 2.2% difference between the theoretical and actual Gross Profit percentages might seem quite small but if we considered a longer period with a Total Net Revenue of £500,000, it would represent £11,000 of lost profit. Variances between theoretical and actual Gross Profit percentages should always be investigated. In the example above the therapist was using too much product, but the effect on the *actual Gross Profit percentage* would be the same if product was being wasted through mishandling or being stolen.

Gross Profit percentages are also useful for comparing different product offers. For example, this might be used to identify the better retail product offer from two competing brands. The brand giving the highest Gross Profit percentage is initially likely to be the better option. However, we can only be sure of this if we take into account *Sales Volumes* and *Price* as these will influence the *Total Gross Profit* achieved. To illustrate this, we can consider two products with different theoretical Gross Profit percentages; Product A (80%) and Product B (50%). If Sales Volumes and Price were the same, say £40, then Product A would be the best choice because it would generate greater a Gross Profit.

$$\text{Product A: } £40 \times 80 \div 100 = £32 \text{ Gross Profit}$$

$$\text{Product B: } £40 \times 50 \div 100 = £20 \text{ Gross Profit}$$

If we now, consider the impact of *Price* and now say Product B retails for a price of £65 at the same Gross Profit percentage, it now produces slightly more Gross Profit than Product A.

$$\text{Product B: } £65 \times 50 \div 100 = £32.50$$

Finally, if we account for differing *Sales Volumes* and say that over a given period Product A at £40 would have a Sales Volume of 100, while over the same period Product B at £65 would have a Sales Volume of 95. Now the better option would be Product A because it would generate a greater Gross Profit.

$$\text{Product A: } 100 \times £40 \times 80 \div 100 = £3200 \text{ Gross Profit}$$

$$\text{Product B: } 95 \times £65 \times 50 \div 100 = £3087.50 \text{ Gross Profit}$$

Managing Gross Profit is, however, not the only financial concern associated with the operation of a successful spa and there are other costs that also need managing. Staff and energy costs are normally the biggest of these additional costs which are deducted from the Gross Profit to leave the *Net Profit*. Net Profit in accounting terms is the final or bottom line profit of the business, but in multi-site or multi-business unit operations, Gross Profit and Net Profit are reported at site or unit level to provide the specific information that managers need to enable them to control the business. The report used to provide this information is known as a *Trading Profit and Loss Report* which shows all of the net revenue and all of the expenditure associated with that revenue over a given period (see Figure 12.1). The report gives information on Net Sales Revenue over the period, the Cost of Goods Sold to generate that revenue and the Gross/Net Profit made by the business.