**ACTIVITY-BASED COSTING IN THE HOTEL INDUSTRY: ENHANCING COST MANAGEMENT FOR IMPROVED PROFITABILITY**

# 1. INTRODUCTION

The adoption of ABC in the hotel industry has evolved over time, driven by the need for more accurate cost information and a deeper understanding of profitability drivers. Traditionally, hotels relied on simple cost allocation methods that distributed costs based on volume-related factors such as room occupancy, number of meals served, or total revenue generated. However, these methods often led to distortions and inaccuracies in cost allocation, as they failed to consider the complexity and diversity of hotel operations.

In the hotel industry, effective cost management is crucial for maintaining profitability and sustaining a competitive advantage. Activity-Based Costing (ABC) is a costing method that provides a more accurate and detailed analysis of costs by linking them directly to the activities that drive them. Unlike traditional costing methods that allocate costs based on arbitrary factors such as labour hours or machine usage, ABC assigns costs based on the activities performed and the resources consumed for that activities.

The purpose of ABC is to enhance cost management by providing a clearer understanding of the true cost drivers within a hotel operation. It aims to allocate costs more accurately to products, services, or activities, enabling managers to make informed decisions regarding pricing, process improvement, resource allocation, and performance evaluation. By identifying and analysing cost drivers, ABC enables hotel managers to gain insights into areas where costs can be controlled and opportunities for revenue enhancement can be explored.

# 2. BENEFITS OF ABC

ABC offers several benefits for the hotel industry:

a) Accurate Cost Allocation: ABC provides a more accurate allocation of costs to products, services, or activities, enabling managers to understand their true costs and profitability. This helps in identifying areas of waste, inefficiency, and cost reduction opportunities.

b) Cost Transparency: ABC enhances cost transparency by breaking down costs into individual activities, making it easier for managers to understand the underlying cost drivers and the factors that contribute to overall costs. This transparency enables better decision-making and facilitates effective cost control.

c) Pricing Precision: ABC enables hotels to establish more precise pricing strategies by incorporating a detailed understanding of costs. By accurately identifying the costs associated with each product or service, hotels can set prices that reflect both profitability goals and market dynamics, maximizing revenue potential.

d) Process Improvement: ABC facilitates process improvement by highlighting activities that are inefficient or have high costs. By identifying and addressing these activities, hotels can streamline their operations, reduce costs, and enhance overall productivity.

# 3. LIMITATIONS OF ABC

Despite its advantages, ABC also has limitations:

a) Implementation Complexity: Implementing ABC requires a significant investment of time and resources, including data collection, analysis, and system setup. The complexity of implementing ABC can pose challenges, especially for hotels with limited resources or outdated information systems.

b) Subjectivity in Cost Driver Selection: Selecting appropriate cost drivers in ABC involves some subjectivity, as it requires judgment in determining the most accurate allocation basis for costs. This subjectivity can introduce biases and potential inaccuracies in cost allocation.

c) Limited Scope: ABC may not capture all indirect costs, particularly those that are difficult to measure or allocate. Some costs, such as shared overhead expenses, may still require some level of estimation or allocation based on indirect methods.

The ABC becomes valuable costing tool for hotels intending to optimize cost management and improve profitability.

# 4. COST CATEGORIES IN HOTELS

Hotels operate in a complex and multifaceted environment, where various cost categories contribute to the overall expenses. Understanding these cost categories is essential for effective cost management. The major cost categories in hotels include:

1. Raw Material Costs: In the hotel industry, like any other business, costs are an essential aspect of financial management. Various cost categories play a significant role in the day-to-day operations and overall profitability of hotels. While raw material costs are relevant in manufacturing industries, hotels have distinct expense categories that are specific to their nature of operation.
2. Labour Costs: Labour costs constitute a significant portion of a hotel's expenses. This includes wages and benefits for hotel staff across different departments, such as front desk, housekeeping, food and beverage, maintenance, and administration.
3. Operating Expenses: Operating expenses cover a wide range of costs necessary for the day-to-day functioning of the hotel. This includes utility bills, maintenance and repairs, property taxes, insurance, marketing and advertising expenses, guest amenities, and general supplies.
4. Cost of Goods Sold (COGS): In the hotel industry, COGS primarily refers to the costs associated with food and beverage operations. This includes the cost of raw ingredients, beverages, alcoholic beverages, and other consumables used in preparing and serving meals and beverages to guests.
5. Overhead Costs: Overhead costs encompass indirect expenses that support the hotel's operations but are not directly tied to a specific department or activity. These costs include rent, property depreciation, administrative salaries, information technology infrastructure, central reservations systems, and other shared services.
6. Sales and Marketing Costs: Hotels incur expenses related to sales and marketing efforts, including advertising campaigns, online marketing, travel agent commissions, loyalty program expenses, and public relations activities.

# 5. LIMITATIONS OF TRADITIONAL COST ALLOCATION METHODS

Traditional cost allocation methods used in hotels often rely on simplistic and arbitrary allocation bases, such as room occupancy or revenue generated, to distribute costs among different departments or activities. These methods have following limitations:

a) Lack of Accuracy: Traditional allocation methods may not accurately reflect the actual consumption of resources by different activities or products.

b) Inadequate Cost Transparency: Traditional methods provide limited transparency into the specific activities or processes that drive costs. This makes it challenging to identify the root causes of high costs or inefficiencies, those result into ineffective cost management and process improvement efforts.

c) Cross-Subsidization: Traditional cost allocation methods can lead to cross-subsidization, where some departments or products end up bearing a disproportionately higher share of costs.

d) Difficulty in Identifying Cost Reduction Opportunities: Traditional allocation methods may mask cost reduction opportunities as they do not provide a detailed breakdown of costs.

# 6. SHIFT TO MORE ACCURATE COSTING SYSTEM

The challenges associated with traditional cost allocation methods highlight the need for a more accurate costing system in the hotel industry. A more precise costing system, such as Activity-Based Costing (ABC), is necessary to address these requirenments and provide a better understanding of cost structures. The need for a more accurate costing system arises from several factors:

a) Diverse Product and Service Offerings: Hotels offer a wide range of products and services, each with varying resource requirements and cost drivers.

b) Complexity of Operations: Hotels consist of multiple departments and activities that contribute to the overall guest experience. Each department incurs different costs and engages in unique activities. A more accurate costing system is needed to capture these complexities and allocate costs accordingly.

c) Competitive Market Environment: In a highly competitive market, hotels must have a thorough understanding of their cost structures to make informed pricing decisions. An accurate costing system provides insights into the true costs associated with each product or service, enabling hotels to set competitive prices while ensuring profitability.

d) Cost Control and Efficiency Improvement: To remain competitive and maximize profitability, hotels need to identify cost reduction opportunities and optimize resource allocation. A more accurate costing system helps in identifying areas of waste, inefficiency, and opportunities for process improvement, leading to better cost control.

By adopting a more accurate costing system like ABC, hotels can gain a deeper understanding of their cost structures and make data-driven decisions for cost management, pricing strategies, process improvement, and overall financial success.

# 7. KEY CONCEPTS AND TERMINOLOGY IN ABC

Activity-Based Costing (ABC) is based on several key concepts and terminologies that form the foundation of its methodology. Understanding these concepts is essential for effectively implementing ABC in the hotel industry:

a) Activities: Activities are the fundamental actions or tasks performed within a hotel. They can be both value-adding and non-value-adding activities. Examples of activities in the hotel industry include room cleaning, check-in/check-out procedures, food preparation, guest inquiries, and maintenance.

b) Cost Pools: Cost pools are accumulations of costs associated with a particular activity or group of activities. They serve as the basis for allocating costs to products, services, or departments. Cost pools can be established based on logical groupings, such as housekeeping costs, front desk costs, or maintenance costs.

c) Cost Drivers: Cost drivers are factors that influence the consumption of resources and, consequently, the costs of activities. They establish the relationship between activities and the costs incurred. Cost drivers can be both volume-based (e.g., number of rooms occupied, number of meals served) and non-volume-based (e.g., number of guest inquiries, number of maintenance requests).

d) Resource Consumption Rates: Resource consumption rates quantify the amount of resources (such as labour hours, machine hours, or materials) required to perform an activity. They determine how costs are allocated to activities based on their resource usage.

e) Cost Allocation: Cost allocation refers to the process of assigning costs from cost pools to specific products, services, or departments based on the consumption of resources. ABC allocates costs more accurately by considering the drivers of resource consumption.

# 8. IDENTIFICATION AND CLASSIFICATION OF COST DRIVERS IN THE HOTEL INDUSTRY

Identifying and classifying cost drivers in the hotel industry is crucial for accurate cost allocation. Cost drivers can vary depending on the specific activities and operations of each hotel, but some common cost drivers in the hotel industry include:

a) Room Occupancy: Room occupancy is a significant volume-based cost driver that affects various costs, including housekeeping, laundry, amenities, and utilities.

b) Food and Beverage Sales: Food and beverage sales volume drives costs related to food preparation, kitchen staff, serving staff, and related supplies.

c) Guest Services: Cost drivers related to guest services can include the number of guest inquiries, guest complaints, or special requests, which impact front desk, concierge, and guest relations costs.

d) Maintenance Activities: Maintenance cost drivers may include the number of maintenance requests, repairs, or preventive maintenance activities, which impact maintenance staff and supplies costs.

e) Events and Banquets: Cost drivers associated with events and banquets can include the number of events, attendees, or services provided, impacting costs related to event planning, staff, setup, and equipment.

It is essential to analyse historical data, conduct activity analysis, and consult with department heads to identify and classify relevant cost drivers specific to each hotel's operations. This ensures accurate allocation of costs and provides meaningful insights into the drivers of hotel expenses.

# 9. APPLICATION OF ACTIVITY-BASED COSTING IN HOTEL OPERATIONS

### COSTING MENU ITEMS AND INGREDIENTS

ABC can be used to accurately cost menu items and ingredients by assigning costs to activities and cost drivers involved in food and beverage operations. The steps involved in costing menu items and ingredients using ABC include:

a) Identify Activities: Identify the activities involved in food and beverage operations, such as food preparation, cooking, plating, and serving.

b) Determine Cost Pools: Establish cost pools for food and beverage activities, such as kitchen costs, serving costs, or bar costs.

c) Assign Costs to Cost Pools: Allocate costs from the general ledger or financial statements to the respective cost pools based on their relevance to the activities.

d) Identify Cost Drivers: Determine the cost drivers that influence the resource consumption and costs associated with each activity. For example, the number of meals served, ingredients used, or labour hours spent on food preparation can be potential cost drivers.

e) Calculate Resource Consumption Rates: Determine the rates at which resources, such as labour hours or ingredients, are consumed by each activity. This involves quantifying the amount of resources required for each activity.

f) Allocate Costs to Activities: Allocate costs from the cost pools to individual activities based on their respective resource consumption rates.

g) Assign Costs to Menu Items: Finally, allocate the costs of activities to specific menu items based on the activities involved in preparing and serving each item. This provides a more accurate reflection of the costs associated with each menu item.

By using ABC to cost menu items and ingredients, hotels can identify the profitability of individual menu items, optimize ingredient usage, and make informed pricing decisions.

### COSTING ROOM TYPES AND AMENITIES

ABC can help cost room types and amenities by assigning costs to activities and cost drivers related to room operations. The steps involved include:

a) Identify Activities: Identify the activities involved in room operations, such as housekeeping, guest check-in/out, room maintenance, and amenities provision.

b) Determine Cost Pools: Establish cost pools for room activities, such as housekeeping costs, front desk costs, or amenities costs.

c) Assign Costs to Cost Pools: Allocate costs from the general ledger or financial statements to the respective cost pools based on their relevance to the activities.

d) Identify Cost Drivers: Determine the cost drivers that influence the resource consumption and costs associated with each room activity. For example, the number of room nights, the number of amenities provided, or the number of maintenance requests can be potential cost drivers.

e) Calculate Resource Consumption Rates: Determine the rates at which resources, such as labour hours, cleaning supplies, or amenities, are consumed by each activity.

f) Allocate Costs to Activities: Allocate costs from the cost pools to individual activities based on their respective resource consumption rates.

g) Assign Costs to Room Types and Amenities: Finally, allocate the costs of activities to specific room types and amenities based on the activities involved in serving each type and providing amenities. This provides a more accurate reflection of the costs associated with each room type and amenity.

By using ABC to cost room types and amenities, hotels can assess the profitability of different room categories, evaluate the cost-effectiveness of amenities, and make informed pricing decisions.

### COSTING SERVICES AND FACILITIES

To cost services and facilities in other hotel departments, similar steps to those in food and beverage and room operations can be followed:

a) Identify Activities: Identify the activities involved in each department, such as spa treatments, concierge services, fitness classes, or facility maintenance.

b) Determine Cost Pools: Establish cost pools for department activities, such as spa costs, concierge costs, or facility maintenance costs.

c) Assign Costs to Cost Pools: Allocate costs from the general ledger or financial statements to the respective cost pools based on their relevance to the activities.

d) Identify Cost Drivers: Determine the cost drivers that influence the resource consumption and costs associated with each department activity. For example, the number of spa treatments, the number of concierge requests, or the usage of fitness facilities can be potential cost drivers.

e) Calculate Resource Consumption Rates: Determine the rates at which resources, such as labour hours, equipment usage, or supplies, are consumed by each activity.

f) Allocate Costs to Activities: Allocate costs from the cost pools to individual activities based on their respective resource consumption rates.

g) Assign Costs to Services and Facilities: Finally, allocate the costs of activities to specific services and facilities based on the activities involved in providing each service or maintaining the facility. This provides a more accurate reflection of the costs associated with each service and facility.

By using ABC to cost services and facilities in other hotel departments, hotels can assess the profitability of different services, evaluate the cost-effectiveness of facilities, and make informed decisions regarding pricing, resource allocation, and service offerings.

### ALLOCATING OVERHEAD COSTS TO OTHER OPERATIONS

ABC can also allocate overhead costs to other hotel departments to determine the true costs of providing those services and maintaining facilities. Similar to food and beverage and room operations, the steps involved in allocating overhead costs include:

a) Identify Overhead Cost Pools: Establish cost pools for overhead costs associated with each department, such as spa overhead costs, concierge overhead costs, or facility maintenance overhead costs.

b) Determine Cost Drivers: Identify appropriate cost drivers that drive the consumption of overhead resources. For example, the number of spa treatments, the number of concierge requests, or the square footage of the facility can be potential cost drivers.

c) Allocate Overhead Costs: Allocate the overhead costs from the cost pools to other department operations based on their respective cost drivers. This ensures that overhead costs are assigned to department activities in proportion to their resource usage.

By accurately allocating overhead costs, hotels can gain insights into the costs of providing various services and maintaining facilities, enabling them to optimize resource allocation, assess profitability, and make informed decisions for those departments.

Implementing Activity-Based Costing in various hotel operations provides a more accurate understanding of costs, improves cost management, supports pricing decisions, and enables hotels to optimize resource allocation and enhance overall financial performance.

# 10. INTEGRATION OF ABC WITH MANAGEMENT INFORMATION DECISION

To maximize the benefits of ABC, integration with existing management information systems is crucial. Consider the following aspects:

a) Data Integration: Integrate ABC data with other financial and operational data systems, such as enterprise resource planning (ERP) systems, to ensure seamless data flow and enable comprehensive analysis and reporting.

b) Reporting and Analysis: Develop customized reports and analysis tools to effectively communicate ABC-generated information to stakeholders. This includes cost reports by activity, department, or product/service, operations, profitability analysis, and variance analysis.

c) Decision Support: Utilize ABC data to support decision-making processes across various functions and operations, such as pricing, product/service mix, resource allocation, and cost reduction initiatives. Enable managers to access relevant information for informed decision-making.

d) Performance Measurement: Use ABC data to develop key performance indicators (KPIs) aligned with strategic objectives. Monitor and evaluate performance against these KPIs, facilitating continuous improvement and proactive decision-making.

By integrating ABC with management information systems, hotels can leverage the power of ABC-generated data to drive strategic initiatives, optimize operations, and enhance overall financial performance.

Implementing Activity-Based Costing in the hotel industry is a comprehensive undertaking that requires careful planning, overcoming challenges, managing change, and integrating ABC with existing management information systems. By following a structured implementation approach and addressing potential obstacles, hotels can harness the benefits of ABC, improve cost management practices, and make more informed decisions to drive their success in a competitive marketplace.

# 11. CONCLUSION

Activity-Based Costing (ABC) is a powerful tool for cost management and decision-making in the hotel industry. This chapter provided a comprehensive overview of ABC, its implementation, and its application in various hotel operations.

The evolution of ABC in the hotel industry can be attributed to advancements in technology, increased competition, and the recognition of the importance of cost management for sustainable profitability. With the availability of sophisticated software tools and systems, hotels have been able to implement ABC more efficiently, enabling them to capture and analyse data at a granular level.

ABC enables hotels to understand their cost structure in greater detail by accurately allocating costs to activities, departments, operations, products, and services. It helps identify cost drivers and opportunities for cost reduction, leading to improved operational efficiency and profitability. Moreover, ABC provides valuable insights for pricing strategies, revenue optimization, and performance measurement.

Implementing ABC in the hotel industry requires careful planning, overcoming implementation challenges, managing change, and integrating ABC with existing management information systems. By following a structured implementation approach and addressing potential obstacles, hotels can effectively leverage the benefits of ABC.

Analysing and utilizing ABC data facilitates informed decision-making in the hotel industry. Interpreting ABC results and cost reports helps hotels understand their cost allocation accuracy, cost hierarchy, and areas of cost inefficiency. Identifying cost drivers and opportunities for cost reduction empowers hotels to optimize their cost structure. Utilizing ABC data for pricing strategies and revenue optimization ensures prices reflect underlying costs and enhances revenue management practices. Performance measurement and benchmarking using ABC data enable hotels to track progress, identify areas for improvement, and make data-driven decisions.

In conclusion, Activity-Based Costing provides the hotel industry with a comprehensive framework to understand costs, optimize operations, and enhance profitability. By implementing ABC and effectively analysing its data, hotels can gain a competitive advantage, improve cost management practices, and achieve their strategic objectives in a dynamic and competitive marketplace.