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Budgets

Learning Objectives

1. To understand the four types of budgets.
2. To understand the importance of the operating budget in analyzing the financial performance for a company.
3. To learn the formulas and steps used to prepare a budget.
4. To be able to prepare an operating budget.
5. To understand preopening and capital expenditure budgets.

Chapter Outline

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Budgets represent an integral part of the financial management of a company. A budget is the formal business and financial plan for a business for one year. It is a plan for the future operations of a company that applies financial goals and measurements to business operations. Budgets, combined with the results from the previous year, are the key measurements of financial success to which current actual financial results are compared.

The primary budget used by department managers is the annual operating budget. It contains the specific revenue goals, the specific expense amounts, and the profit objectives that the department is expected to meet. Managers use the budgeted amounts to operate their departments. They are expected to achieve the revenue budget and spend no more than the expense budgets to achieve budgeted profits.

There are three other types of budgets. The **construction budget** establishes the cost to physically contruct the hotel. It includes architectural drawings, design and decor engineering and all actual construction costs such as permits and fees, code compliance, materials and labor. The **preopening budget** establishes amounts that are expected to be spent by management to open a new hotel or restaurant. It is the dollar amount needed to cover all expenses before the hotel or restaurant opens and starts to record revenues. It is separate from the construction budget. The **capital expenditure budget** identifies expenditures that are necessary to replace long-term assets, renovate, or to expand the business. It is a form of capitalization.

Operating managers must be knowledgeable about their department operating budget as they manage their daily operations. The budget is both a management tool and a way to measure financial performance. They must also understand the capital expenditure budget to plan for and obtain long term assets for their operation.

The Use of Budgets in Business Operations

The purpose of budgets is to provide a financial plan for a business for the next fiscal year. The annual budget generally includes an operating budget and a capital expenditure budget. Annual budgets are prepared based on the actual financial results for the previous year. Because a fundamental concept of business operations is that a business will grow from year to year, the annual budget will plan for growth and improvement

J.W. Marriott Starr Pass Resort & Spa
Tucson, Arizona

The J.W. Marriott Starr Pass Resort and Spa opened in January 2005 and is the newest resort in Arizona. It is located adjacent to the Tucson Mountain Park preserve and offers award winning views in every direction. It offers 575 guest rooms and over 88,000 square feet of meeting space. Resort recreational activities feature a 27 hole Arnold Palmer signature golf course, 20,000 square foot Hashani Spa, and expanded water recreation. It definitely provides the ambiance of the southwest desert.

over the last year's financial results. These goals are included in the annual operating budget.

What do you think the challenges are in opening a new resort or hotel, especially of this size? The owners and managers need to work with three budgets. First is the construction budget that includes all the costs to build the resort. Second is the pre-opening budget that includes all of the costs to get ready to open the resort such as sales and marketing, employee hiring and training, and the cost to furnish the resort with operating supplies. Third is the operating budget that includes all the expected revenues and expenses to operate the resort in the first year. This first-year budget is also called the Pro Forma.

Definition

The annual operating budget is the formal business and financial plan for a business for one year. The operating budget contains the details of department operations including revenue goals that the business or department is expected to achieve and the necessary expense amounts that the business will require to achieve the budgeted revenue for the next year.

The annual operating budget (also refined to as the **department budget**) contains the details and specifics of the financial operations of a business or department for one year. Characteristics of annual operating budgets are as follows:

1. They are a plan for the next year; therefore they plan future operations.
2. They are for one fiscal year.
3. They are based on the previous year's actual financial results.
4. They include growth and financial improvements over the previous year.
5. They include dollar amounts, percentages, and units or statistics.
6. The budget column is included on monthly profit and loss statements and provides a comparison for actual financial results.
7. It includes the hotel's current marketing plan.

Operating budgets are prepared for each department in a hotel. They are prepared monthly or by accounting period. If a business operates on monthly Profit and Loss (P&L) Statements, it will prepare a budget for each month of the year. Adding the department budgets for the 12 months will result in the annual operating budget for the business. If a business operates on accounting period P&L Statements, it will prepare a budget for each week of the four-week accounting period. Adding the department budgets for the 13 accounting periods will result in the annual operating budget for the business.

The Director of Finance for a hotel has the main responsibility for preparing the annual operating budget. This is because he or she is the financial expert for the hotel and not only prepares the monthly financial reports but also analyzes and critiques them with the operations managers. Each year when the budget process starts, the Director of Finance will work with each Executive Committee member and the department managers to prepare the budget for next year. The budget is then submitted to the General Manager for approval and then is forwarded to the corporate office for final approval.

All of the department annual operating budgets are added together to make the **consolidated hotel budget**. This budget summarizes all the revenues and profits for the revenue departments and total department costs for the expense departments.

For a company with a fiscal year ending December 31, the budgeting process will generally start in October and be completed in November. Final approval should be received in December so that the budget is in place when the new fiscal year starts January 1. Once the annual operating budget is approved, it is not changed. It represents the formal and final operating plan for the year. Weekly or monthly forecasts are used to update the budget. As business conditions change, a forecast is developed to reflect these changes. Forecasts can increase or decrease revenues, expenses, or profits. Therefore, actual monthly financial performance can be compared to three important measurements: last year, the budget, and the most recent forecast.

Capital expenditure budgets are also prepared annually and identify the needs for replacing long-term assets of the business, renovating the business, or expanding the business. Capital expenditure budgets generally involve projects or equipment that cost a lot of money and last longer than one year of operations. This involves capitalization and not working capital. Characteristics of capital expenditure budgets are as follows:

1. They identify purchases of specific pieces of equipment, such as a laundry machine, airport van, kitchen oven, or mechanical motor.
2. They identify projects that involve many pieces of equipment or activities, such as rooms soft-goods redo, restaurant renovation, or expansions.
3. Budget items must have a useful life of more than one year.
4. Budget items must have a minimum cost.
5. Projects must contain the details of all expenditures necessary to complete the project.
6. Expenditures have different approval levels. For example, items costing less than $5,000 can be approved by the General Manager, whereas items costing more than $5,000 need corporate approval.
7. Small expenditures can be included in one list, totaled, and approved.
8. Large expenditures are itemized and approved one by one.

Capital expenditure budgets can be funded in several ways. The first is to have owners contribute the amount necessary to purchase capital expenditure equipment or to complete capital expenditure projects. Second, the hotel contributes money from its annual operations to a capital expenditure **escrow reserve** that can be used to fund capital expenditure projects. Third, outside financing can be used, such as obtaining bank loans, utilizing a line of credit, or obtaining a lease.

Preopening budgets are established to guide a new company as it prepares to open for business. This budget identifies all the costs that will be incurred to get the business ready to open. Characteristics of a preopening budget include the following:

1. Wage expenses for all employees working before the business opens.
2. Advertising and promotional expenditures.

3. The costs of all the items necessary to furnish the hotel or restaurant, such as guest room furniture and amenities, restaurant furniture and supplies, and kitchen equipment and supplies.
4. The total cost is established for all expenses before opening.
5. The total cost is spread over or paid back over a predetermined time period.

Preopening budgets are prepared based on expected operations and expenses necessary to start up a new business. This can be tricky or difficult as there are no specifics or concrete information to base these budgets on. These budgets are true estimates, and often additional expenditures occur that need to be added to the original amount.

Construction budgets are very complicated and detailed. They include the cost of designing and planning, materials and equipment necessary to build, and all the wage cost of the labor to build a hotel or restaurant. Many specialists are involved in preparing construction budgets to identify as accurately as possible the cost of materials and labor to construct the project. These budgets generally involve the owner, the managers involved in a management contract, franchisees if appropriate, and any other parties involved in financing, developing, and building the project. Operations managers rarely get involved with these budgets.

Annual Operating Budgets

Consolidated Hotel Budgets

The consolidated hotel budget contains the summary financial information for the entire hotel. Its main purpose is to present the key financial results for all of the hotel departments. Characteristics of a consolidated budget are as follows:

1. Presents the total revenues, expenses, and total profits for operating departments in the hotel.
2. Presents the total expenses for the staff or supporting departments in the hotel.
3. Includes the hotel profit budgets for Department Profit, Total Department Profits, House Profit, Net House Profit, and Total Profit before and after Taxes.
4. Contains all of the pertinent summary financial information for the hotel.
5. Does not contain detailed budget information for line accounts.

The consolidated hotel budget is used by senior management and owners to get a quick summary of the planned financial results for a business. When the budget is prepared, reviewed, and approved, it becomes the formal operating plan for the next year. It therefore shows what the financial expectations are for the coming year. The actual financial results are compared each month to the budget to determine if the budgeted operational and financial results are achieved.

Department Budgets

The department budgets contain the detailed budget information for a specific department. Operations managers use these budget amounts as management tools in the daily operations of their departments. This budget can also be considered a roadmap of where the department operations should go and what financial results they should produce. Characteristics of a department budget are as follows:

1. Contains the detailed revenue budget for the department, including market segments, average room rates or average guest checks, and volumes such as rooms sold and customer counts.
2. Contains the budgeted amount for expenses for each line account.
3. Contains detailed wage budget guidelines including labor hours, average wage rates, and total wage costs for specific wage departments.
4. Provides detailed operating information that is used as a management tool.
5. A specific Executive Committee Member is responsible for specific department budgets.
6. A department head has the direct responsibility for meeting the department budget goals.

The department budget contains many pages compared to one page for the consolidated budget. This is because of the amount of detailed operating and financial information included in the department budget. Following are examples:

Revenue Budgets—Market Segments or Meal Periods

In the Rooms Department budget, the market segments provide average room rates, number of rooms sold, and total revenue for transient, group, and contract market segments. In the Restaurant Department budget, the meal periods include average checks, customer counts, and total revenues for breakfast, lunch, and dinner. In a typical 400-room full-service hotel, the revenue budget for the Rooms and the Food and Beverage Departments will each be several pages long.

Expense Budgets—Wage Departments

In the larger operating departments such as housekeeping and restaurants, hourly wages are separated into specific wage departments for more effective control. Each of these wage departments contains average wage rates, labor hours, and total wage cost. For example, housekeeping includes the following wage departments: housekeepers, supervisors, housemen, and public space. The wage budget includes average wage rates, labor hours, and total wage costs for each of theses wage departments. In the restaurant, the wage departments include servers, hostesses, busers, and cashiers. In the kitchen, the wage departments include station attendants, cooks, lead cooks, and expeditors.

Direct Operating Expense Accounts

These line accounts are not as detailed because they do not involve rates or volumes. Rather, they include all the purchases, inventory consumption, and transfers for a specific line account. For example, the guest supply account in the rooms department includes all of the purchases from outside vendors, issues from inventory, and transfers from other departments for guest supply items including soap, shampoo, condenser, pens, stationcry, and tissue. The total expenses for the china account, glass account, and silver account in the restaurant include all of the purchases from outside vendors, issues from inventory, and transfers from other departments during the month or accounting period.

Profit Budgets

The profit budgets do not contain any detailed information as do the revenue and expense budgets because the profit budget is calculated by subtracting total expenses from total revenues. This simple formula can involve many market segments and expense line accounts to get to the total department profit. The budgeted department profit is typically considered the most important measurement of financial performance.

Fixed Department Budgets

This budget generally includes only one department where all of the fixed expenses of operating the hotel are recorded. They are identified by single line accounts where entries are made to record the appropriate costs for the month or accounting period. For example, monthly bank loan payments are recorded in the bank loan line account, monthly insurance costs are recorded in the insurance line account, and the monthly cost of annual licenses and fees is recorded in the license line account. The most detail is contained in the depreciation account where fixed monthly depreciation costs are recorded for property, plant, and equipment.

Department managers do not get involved with managing fixed expense departments because these costs are predetermined and are not managed or changed during the month. The accounting department generally records and reviews the costs in these departments.

Formulas and Steps in Preparing a Budget

It is important for hospitality managers to be involved in the preparation of their annual department operating budget. This requires a good understanding of both daily operations and the accounting concepts and methods of financial analysis that will be used to evaluate their performance.

The Goals of an Operating Budget

These goals are used to provide a financial guideline for measuring financial performance and to provide a management tool to help achieve expected financial results. The operating budget combines last year's results with planned growth and improvements to project financial expectations for the next year. It is indeed a roadmap for operations for the next year. Actual operating results and financial performance are compared to the budget and any variations identified and explained.

When the budget is not met for a month or accounting period, operations management critiques the operations to identify problems and work on solutions to correct those problems. These budget variations identify problems and successes in operations, and management can deal with each as appropriate. By identifying problems, budget variations red-flag areas that management needs to analyze to identify problems and make corrections. By identifying successes, budget variation can reinforce positive changes that have resulted in improved financial performance or growth.

Methods of Preparing Budgets

These methods include several options that can be used depending on the goals for the budget. A business will generally use the same method from year to year to be consistent. The important point to consider in choosing a method to prepare a budget is, will it provide the necessary detail to produce the expected financial results?

Zero-Based Budgeting is a budgeting method that involves preparing each year's budget from actual needs and costs. No goals or historical information is used. It is a bottom-up budgeting approach that is very detailed and involves many specific formulas. For example, preparing a zero-based budget for guest supplies in the rooms department involves calculating the historical cost per rooms sold for each item classified in the guest supply line account. Shampoo cost per occupied room, soap cost per occupied room, and pens and stationery cost per occupied room are all multiplied by the budgeted number of rooms sold by month and for the year to establish the guest supply budget.

Historical Budgeting is a budget that is based on last year's actual expenses. Last year's actual expenses establish the base, and the budget is adjusted up or down based on changes in volumes, material costs, inflation, or operations. For example, preparing a historical budget for guest supplies in the Rooms Department involves identifying last year's actual costs and then increasing them by a certain percentage based on changes in any of the variables that are appropriate and that would apply to the next year's costs. If inflation is expected to increase 4% and rooms sold are expected to increase 1%, then the budget for guest supplies will be last year's actual expense increased by 5%.

Goal-Based Budgeting is a budget that is based on an established goal determined by the corporate office, senior management, or owners. This is a top-down budgeting approach. The corporate office gives the business a number or target, and the business fills in the budget details to meet the goals. If management wants revenues to increase 5% and profits to increase 6%, then the budget will be prepared based on last year's actual results and increased 5% in revenues and 6% in profits. Although this is an easy and quick way to prepare a budget, the danger is that it may or may not accurately reflect what is happening in the business and the current market.

Revenue Formulas

Revenue budgets are prepared by using the basic revenue formula of rate × volume for each market segment in the Rooms Department or meal period in the restaurants. Management identifies how increased revenues can be achieved by either increasing rooms sold or increasing average room rates if demand is strong. If demand is not strong, it will be difficult to increase rooms sold or average rates. Management makes the decision when and how any increases in rooms sold or average rate can be realistically achieved and put into the budget for the next year.

The Zero-Based Budgeting approach takes each day and determines the number of rooms expected to be sold for each market segment. These rooms sold are then multiplied by the average room rate budgeted for the market segment to calculate the budgeted room revenue. Adding all the market segments together will get the total room budget for the day. The days are totaled to get the weekly and monthly budgets.

The Historical Budgeting approach takes historical daily averages of rooms sold and adds the expected percentage increase to get the total rooms sold budget for a day. This can also be done for a week at a time. The weekly totals then have to be broken down into the daily budgeted rooms sold. The budgeted average rate is then multiplied by the budgeted rooms sold to get the total revenue budget for the day.

The Goal Budgeting approach involves the owner or corporate office establishing the amount of revenue increases expected for the next year's budget. The budget is then prepared by filling in the rooms sold and average room rates necessary to meet the established budget.

Expense Formulas

Expense budgets are prepared differently for the four major expense categories and involve historical averages and relationships between volume expressed as revenue or units such as rooms sold.

Cost of sales budgets can be prepared using any of the three budgeting methods. Zero-based food cost budgets are prepared by costing out each menu item and multiplying by the menu counts for that item. All the items are added to determine the food cost budget in dollars and as a percentage. Historical food cost budgets are based on the actual food costs and changed by any expected price increases or productivities to determine food cost in dollars and as a percentage. Goal-based food cost budgets are determined by the food cost percentage established by the owner or corporate office.

Wage budgets are the most complicated and detailed to prepare. The hourly employee wage cost budgets are generally prepared by a Zero-Based Budgeting approach. Formulas such as labor hours per occupied room or labor hours per customer are applied to budgeted rooms sold or customer counts. These labor hours are then multiplied by expected average wage rates to determine the wage cost budget in dollars. Wage budgets can also be prepared more quickly using the historical budgeting method by taking the average labor hours or wage cost and changing them based on inflation or any changes in volume levels. For example, if revenues increase 5%, then the historical wage cost will be increased by 5%.

Benefit budgets are relatively simple to prepare. The formula used is the historical benefit cost percentage calculated by dividing the actual benefit expense by the actual wage cost. The resulting benefit cost as a percentage of wages cost is multiplied by the new wage budget to get the new benefit budget.

Direct operating expense budgets are prepared by using many formulas that best express the relationship between expense costs and volume levels. These include the following:

1. Historical average involves taking the average cost over a specific time and using that amount for the budget. An example is if the historical average linen cost per month is $7,000, then the new budget amount will be $7,000.
2. Historical average plus inflation or cost increases involve applying expected changes to historical average cost. If the linen vendor in our previous example is increasing linen cost 5%, then we would multiply $7,000 by 5% to get our new linen budget of $7,350.
3. Percentage of sales involves using the relationship between expense costs and revenues. An example is a cleaning supplies expense of 0.3% of room's sales. This percentage is calculated by dividing the cleaning supply expense by total room sales. The new cleaning supply budget would be budgeted room sales multiplied by 0.3%.
4. Cost per occupied room or cost per customer served involves using the relationship between expense costs and rooms sold. This is similar to cost percentage but uses the relationship of expense in dollars divided by total rooms sold. An example is the guest supply expense divided by total rooms sold of $1.15 per occupied room. The guest supply budget would be calculated by multiplying the budgeted rooms sold by the $1.15 cost per occupied room.
5. Specific formulas are used to budget based on established costs. For example, the central reservation budget could be based on the formula $5 per reservation made through the central reservation office. The reservation cost budget would be calculated by multiplying the expected number of reservations by $5.
6. Allocations use formulas to spread the cost over several departments by established allocation percentages. An example is allocating laundry department costs charged

back to the rooms, restaurant, and banquet departments based on the number of items washed or the number of pounds of linen washed from each department. A typical laundry department allocation might be rooms 70%, restaurant 10%, and banquet 20%.

7. Contract budgeting involves taking the dollar amount of an annual contract and spreading the cost back to each month. For example, a $24,000 annual contract for outside window cleaning would be budgeted at $2,000 per month.

Profit Budgets

The formula for profit is revenues minus expenses. The profit budgets are therefore determined by making this calculation. Budgeted department revenues minus all the budgeted department expenses equal budgeted department profit. Compared to budgeting revenues and expenses, this is a rather basic calculation. All of the department profits are added to produce total hotel profit, or total hotel expenses are subtracted from total hotel revenues to produce total hotel profits.

Capital Expenditure Budgets

The primary concern of hospitality managers is the operating budget as it is the financial report by which their operations will be evaluated. We briefly discussed other budgets used in business that a manager should be aware of, specifically the preopening budget and the construction budget referred to earlier in the chapter. The Director of Finance at a hotel is generally responsible for these budgets.

A hospitality manager should also have a general awareness and understanding of the capital expenditure projects (CEP) budget, because this budget plans the financial needs for long-term equipment and other operating requirements.

Definition

Capital Expenditure Budgets identify the need for replacing long-term assets of the business, for renovating the business, and for expanding the business. When a business is started, the capitalization determines the amount of investment necessary to launch the business and identifies where the expenditures on **property**, **plant**, **and equipment** (PP&E) will be made. These expenditures are long term in nature, and the PP&E will last from 1 to 30 years.

Characteristics

Let's review the characteristics of capital expenditure budgets that were presented earlier in the chapter:

1. They identify purchases of specific pieces of equipment, such as a laundry machine, airport van, kitchen oven, or mechanical motor.
2. They identify projects that involve many pieces of equipment or activities, such as rooms soft-goods redo, restaurant renovation, or expansions.
3. Budget items must have a useful life of more than one year.
4. Budget items must have a minimum cost.
5. Projects must contain the details of all expenditures necessary to complete the project.
6. Expenditures have different approval levels. For example, items costing less than \$5,000 can be approved by the general manager, whereas items costing more than \$5,000 need corporate approval.
7. Small expenditures can be included in one list, totaled, and approved.
8. Large expenditures are itemized and approved one by one.

Because the items and equipment (PP&E) are quite different from the expenses budgeted in annual operating budgets, the CEP is prepared in a different way.

Preparing Capital Expenditure Budgets

Capital Expenditure Budgets are prepared based on the needs of the hotel or restaurant. Replacing major equipment and completing major renovations involves a great deal of operational and financial planning because the results of these budgets will last many years and will generally involve larger amounts of money.

Identifying Capital Expenditure Projects and Needs

During the year, department heads identify equipment that needs replacing or areas of the hotel that need to be upgraded or renovated. These capital needs are divided between those with small costs that are easily replaced and those with large costs that are more complicated to complete. Estimates are obtained, and all projects are reviewed by the Executive Committee Member and then submitted to the Director of Finance.

The Director of Finance accumulates all capital expenditure requests and categorizes them according to size and type of expenditure. The main categories are as follows:

1. Equipment costing less than a set amount; for example, less than \$2,500
2. Equipment costing more than a set amount; for example, more than \$2,500
3. Projects costing less than a set amount; in our example, less than \$2,500
4. Projects costing more than a set amount; in our example, more than \$2,500

All equipment and projects that cost less than the \$2,500 amount will be listed one capital expenditure list as one amount and approved all together. Then it will be the hotel's responsibility to complete each project within the dollar amount budgeted for that item.

Equipment and projects that cost more than the $2,500 amount will be listed separately and contain all the necessary information describing the equipment or project and the dollar cost involved to complete the project. There can be many pieces of equipment, types of construction, and dollar costs in these project budgets. For example, a restaurant redo might include the cost to purchase several items such as new tables, chairs, point-of-sale equipment, and carpet. It also includes the cost to install the carpet, repaint the restaurant, and replace any wall coverings. A project with 15 items includes the cost for each item and the total for all items. The final project cost includes expenses such as materials and supplies, labor, permits and fees, and taxes.

Most of the time, CEP requests are more than the amount available in CEP escrow or reserve accounts. The General Manager reviews the CEP list prepared by the Director of Finance with the Executive Committee and then determines which projects to keep on the list and which projects to cancel or defer to the next year. Once the CEP budget is approved, the hotel can proceed to purchase the equipment or start the projects but must remain within the established budget. If there are cost overruns, the hotel might have to cancel other projects and use that approved budget amount to pay for the cost overruns.

Funding Capital Expenditure Projects

Funding to pay for capital expenditure projects could be obtained from outside sources such as bank loans or owner contributions. However, the main way to finance these projects is from the cash flow generated from business operations.

A company will determine what percentage of sales that it is willing to set aside in capital expenditure reserve or escrow accounts. A new hotel will not require as much additional capital investment as an older hotel that has equipment and materials that are wearing out and in need of replacement. A new hotel might set aside 3% of total sales, whereas an older hotel might set aside 5% of total sales.

Let's use an older hotel as an example. If the total annual sales for the hotel are $20 million, 5% of that amount, or $1 million, will be set aside in the CEP escrow or reserve account. That means that the hotel will have $1 million to allocate and spend on CEP projects for the year. Each month, the Director of Finance will make an accounting entry and transfer funds from the cash account to the CEP escrow or reserve account. When equipment is purchased or projects completed, a check will be drawn from the CEP account to make payments.

Operating managers do not generally get involved with CEP accounting, as that is done by the Director of Finance. However, they will be very involved in choosing the equipment to ensure that it meets requirements and stays within the budgeted costs and overseeing projects to ensure that the work is completed as planned and also stays within the CEP budget. It can become very competitive among departments to obtain approval and funding for equipment and projects that they need. A Hospitality Manager's ability to clearly explain and justify any CEP projects will be an important factor in securing approval for those projects.

Summary

Budgets play a critical role in the success of any business. Budgets connect actual operations with financial needs and results. They are the annual formal financial plan for the next year of operations. Management's actual performance is evaluated against the budget to determine if expected results have been achieved.

Annual operating budgets are used to plan for the next year and to evaluate actual financial performance from month to month and for the year. Hospitality managers are involved with the preparation of their department budgets and will use that budget in planning their department operations. Operating budgets include the detailed financial plans for revenues, expenses, and profits.

Several other budgets are used in business besides the annual operating budget. The capital expenditure budget plans for the long-term needs of the business and has an impact on many years of business operations. Hospitality managers need to understand and be involved in the preparation of capital expenditure budgets to be able to secure additional investments and capital expenditures. Other budgets include preopening and construction budgets administered by the Director of Finance. Hospitality managers are generally not involved with these budgets.

Hospitality Manager Takeaways

1. **Operations managers must have a complete understanding of their operating budgets and be able to use them in their daily operations. Budgets are a key management tool.**
2. **Operations managers must have the ability to prepare their budgets and be actively involved in the budget approval process.**
3. **Hospitality managers must understand and be able to use appropriate budgeting formulas for revenues, wages, and other operating expenses.**
4. **Actual department financial results will be compared to the budget and to last year to evaluate the success of operating results.**
5. **Capital expenditure budgets are very important and provide the long-term equipment needs and plan for renovation projects that are essential in department operations.**

Key Terms

Annual Operating Budget—The formal business and financial plan for a business for one year.

Consolidated Hotel Budget—The summary budget for the entire hotel including revenues, expenses, and profits.

Department Budget—The specific and detailed budget for an individual department that provides all of the financial specifics for revenues and expenses.

Capital Expenditure Budget—The formal budget that identifies the need for replacing long-term assets of the business, for renovating the business, and for expanding the business.

Construction Budget—The budget that identifies the costs needed to construct and build a hotel or restaurant.

Escrow—An account established to collect money to be used at a later date. Same as reserve account.

Preopening Budget—The budget established to guide a new business as it prepares to open for business.

Property, Plant, and Equipment (PP&E)—The term used to identify the long-term investments that will serve the business for more than one year.

Reserve—An account established to collect money to be used at a later date. Same as an escrow account.

Review Questions

1. Why is the annual operating budget one of the most important financial reports for a hospitality manager to know, understand, and use?
2. Name five characteristics of an annual operating budget.
3. Why is a capital expenditure budget important, and how do hospitality managers use it in operating their departments?
4. Name five characteristics of a capital expenditure budget.
5. What is the difference between a consolidated hotel budget and a department budget?
6. Name five ways to budget direct operating expenses.

7. Name and describe the three main ways to prepare an operating budget.
8. How is a budget used to evaluate actual financial performance?

Problems

There are two budget problems to complete. The first is to calculate amounts to use in budgeting based on actual information and formulas. The second is to prepare an annual budget based on that information. Following is information for the Rooms Department for the 600 room Flagstaff Hotel for the first six periods of the year:

Room Revenue				$8,713,000
Transient Rooms Sold	83,730			
Group Rooms Sold	16,270			
Total Rooms Sold	100,000			
Operating Expenses				
Linen			$ 31,100	
Cleaning Supplies			24,000	
Guest Supplies			104,800	
Outside Services			24,000	
Laundry			80,500	
Concierge Expense			60,000	
Office Supplies			19,200	
Reservation Expense				
Reservation Department		$150,000		
Fixed Reservation Center Cost		180,000		
Variable Reservation Center Cost		251,400		
Total Reservation Expense			581,400	
All Other Expense			120,000	
Total Operating Expenses				$1,045,000
Total Operating Expenses Percentage				12.0%

Problem 1

Use the following formulas to calculate each one of the line items. They will be used to prepare the annual budget for next year. Round the average cost per period to whole dollars, round the cost per occupied room to whole cents, and round the percentage of sales to four decimals. Use the laundry and reservation information as supplied.

1. Linen—Calculate the average cost per period.
2. Cleaning Supplies—Calculate the average cost per occupied room.
3. Guest Supplies—Calculate the average cost per occupied room.
4. Outside Services—Calculate the average cost per period.
5. Laundry—Calculate at 70% of total laundry department expense per period; laundry department expense at $115,000 for six periods.
6. Concierge Level Expense—Calculate as a percentage of total room sales.
7. Office Supplies—Calculate as a percentage of total room sales.
8. Reservation Cost
   a. Reservation department cost at $25,000 per period.
   b. Fixed expense at $50 per total number of rooms in hotel per period.
   c. Variable expense at $6 per reservation. Calculate the reservations as 50% for transient rooms sold.
9. All other expense at $20,000 per period.

Answers Problem 1

Use the following formulas to calculate each one of the line items: They will be used to prepare the annual budget for next year. Round the average cost per period to whole dollars, round the cost per occupied room to whole cents, and round the percentage of sales to four decimals. Use the laundry and reservation information as supplied.

1. Linen—Calculate the average cost per period:

   $5,183 per period
2. Cleaning Supplies—Calculate the average cost per occupied room:

   $0.24 per occupied room
3. Guest Supplies—Calculate the average cost per occupied room:

   $1.05 per occupied room
4. Outside Services—Calculate the average cost per period:

   $2,000 per period
5. Laundry—Calculate at 70% of total laundry department expense per period; laundry department expense at $115,000 for six periods:

   $13,416 or $115,000 × 70%/6 periods
6. Concierge Level Expense—Calculate as a percentage of total room sales:

   0.69% of sales

7. Office Supplies—Calculate as a percentage of total room sales:

   0.22% of sales

8. Reservation Cost per period:

   a. Reservation department cost at $25,000 per period:

      $25,000 per period

   b. Fixed expense at $50 per total number of rooms in hotel per period:

      $30,000 or 600 rooms × $50

   c. Variable expense at $6 per reservation. Calculate the reservations as 50% of transient rooms sold:

      $251,190 or 83,730 × 50% × $6

9. All other expense at $20,000 per period:

   $20,000 per period

Problem 2

Prepare the annual operating expense budget for the next year using the formulas from Problem 1 and the following assumptions. Remember there are 13 accounting periods in a fiscal year, each with four weeks and 28 days.

Room Revenue		$19,184,000
Transient Rooms Sold	184,000	
Group Rooms Sold	34,000	
Total Rooms Sold	218,000	
Operating Expense Annual Budget		
Linen		
Cleaning Supplies		
Guest Supplies		
Laundry		
Concierge Expense		
Office Supplies		
Reservation Expense		
Reservation Department Cost		
Fixed Reservation Center Cost		
Variable Reservation Center Cost		
Total Reservation Expense		
All Other Expense		
Total Operating Expenses in Dollars		
Total Operating Expenses as a Percentage		

Answers Problem 2

Prepare the annual operating expense budget for the next year using the formulas from problem 2 and the following assumptions. Remember there are 13 accounting periods in a fiscal year, each with four weeks and 28 days.

Room Revenue			$19,184,000
Transient Rooms Sold	184,000		
Group Rooms Sold	34,000		
Total Rooms Sold	218,000		
Operating Expense Annual Budget			
Linen $5,183 × 13 Periods		$ 67,379	
Cleaning Supplies .24 Cents × 218,000 Rooms Sold		$ 52,320	
Guest Supplies $1.05 × 218,000		$228,900	
Laundry $250,000 × 70% Annual Laundry Department Budget $250,000		$175,000	
Concierge Expense .69% × $19,184,000		$132,370	
Office Supplies .22% × $19,184,000		$ 42,211	
Reservation Expense			
Reservation Department Cost $25,000 × 13 Periods	$325,000		
Fixed Reservation Center Cost 600 Rooms × 13 Periods × $50	$390,000		
Variable Reservation Center Cost 184,000 × 50% × $6	$552,000		
Total Reservation Expense		$1,267,000	
All Other Expense $20,000 × 13 periods		$ 260,000	
Total Operating Expenses in Dollars		$2,225,180	
Total Operating Expense as a Percentage		11.6%	