

## **COST ACCOUNTING**

### **Option 1: Cost Allocation In Tourism:**

### **“Analyzing the Role of Activity-Based Costing (ABC) in Tourism Businesses”**

# **Activity-Based Costing (ABC)**

*The Profitability Lens for Tourism Businesses*



Moving beyond volume-based metrics to uncover the true cost of service delivery in hotels, airlines, and tour operations.

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## 1. Abstract:

The tourism and hospitality industry currently operates within a hyper-competitive landscape defined by rising operational costs, fluctuating demand, and increasingly fragmented consumer preferences. Traditional financial management practices, particularly volume-based cost allocation methods, often fail to capture the economic reality of complex service environments. These outdated methods frequently result in significant cost distortions, leading managers to make flawed decisions regarding pricing, product mix, and customer segmentation. This comprehensive assignment critically evaluates the role of Activity-Based Costing (ABC) as a strategic antidote to these financial inefficiencies. By shifting the focus from volume metrics (such as room nights) to activity consumption (such as check-ins, concierge requests, or itinerary customizations), ABC provides a high-definition view of profitability. Through an extensive review of literature and the analysis of detailed simulated case studies—specifically within hotel operations and tour packaging—this report demonstrates that ABC reveals the "true" cost to serve different market segments. The findings indicate that while ABC requires a higher initial investment in data collection, it enables more accurate Customer Profitability Analysis (CPA), facilitates dynamic pricing strategies, and uncovers hidden inefficiencies in overhead-heavy operations. The report concludes by recommending a phased implementation of Time-Driven ABC (TDABC) to overcome barriers to adoption, ultimately arguing that accurate cost allocation is a prerequisite for sustainable financial performance in the modern tourism economy.

## 2. Introduction:

### 2.1 Background of the Study

The global tourism industry has undergone a paradigm shift over the last two decades. It has transitioned from a standardized, mass-market model—characterized by package holidays and uniform hotel experiences—to a highly segmented, experience-based economy. Today's travelers demand personalization, flexibility, and unique experiences. While this shift offers opportunities for revenue growth, it also introduces significant operational complexity. Each layer of personalization—whether it's a customized dietary request at a resort or a bespoke itinerary for an adventure traveler—adds a layer of cost that is often invisible in traditional financial statements.

In the wake of recent global economic disruptions, including the post-pandemic recovery and inflationary pressures on labor and energy, financial discipline has become paramount. Tourism businesses, specifically hotels and tour operators, are asset-heavy and labor-intensive. The margin for error is slim. Consequently, the ability to accurately trace costs to specific services and customers is no longer a luxury for large multinationals; it is a survival necessity for businesses of all sizes.

### 2.2 Problem Statement: The Cost Distortion Dilemma

The core problem addressed in this assignment is the prevalence of "cost distortion" arising from Traditional Costing Systems (TCS). TCS was originally designed for the manufacturing era of the early 20th century, where direct labor and materials constituted the bulk of production costs, and overheads were minimal and homogenous.

In modern tourism, this cost structure is inverted. Direct costs (like the cost of food ingredients or housekeeping supplies) are often dwarfed by indirect overheads (marketing, administration, IT infrastructure, front-office salaries, and utilities). When businesses allocate these massive overhead pools based on simple volume drivers—such as "direct labor hours" or "number of guests"—they invariably over-cost simple, high-volume products and under-cost complex, low-volume specialty services. This leads to cross-subsidization, where the profitable "bread and butter" customers unknowingly pay for the unrecovered costs of high-maintenance "premium" clients. Without the lens of Activity-Based Costing, management remains blind to these value-destroying dynamics.

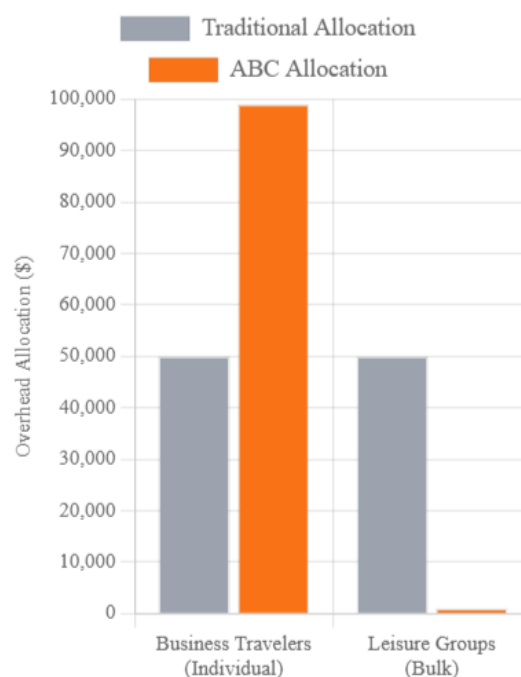
### Hotel Scenario Analysis

Consider two segments booking 1,000 nights each. Under traditional costing, overhead is split 50/50. Under ABC, we track "Check-in" activities.

**A Business Travelers:** Arrive individually. 1,000 separate check-in transactions. High resource use.

**B Leisure Group:** Arrives on one bus. 1 bulk check-in transaction. Low resource use.

#### Cost Allocation Comparison (\$)



*Goal: Compare (Distortion Effect)*

## 2.3 Research Objectives

This assignment aims to achieve the following objectives:

1. **To critically review** the evolution of cost accounting and its applicability to the service-oriented nature of the tourism industry.
2. **To analyze** the theoretical framework of Activity-Based Costing (ABC) versus Traditional Costing.
3. **To demonstrate**, through simulated case studies, how ABC changes the reported profitability of different customer segments and products in hotels and tour operations.
4. **To evaluate** the strategic implications of ABC for pricing, revenue management, and operational decision-making.
5. **To provide actionable recommendations** for tourism managers seeking to implement ABC to enhance financial control and profitability.

## 2.4 Significance of the Study

This study is significant because it bridges the gap between accounting theory and operational reality in tourism. For students and practitioners alike, understanding ABC is crucial for modern financial literacy. It moves the conversation beyond simple cost-cutting (which often degrades service quality) toward "strategic cost management," where resources are optimized to create maximum value.

## 3. Literature Review:

### 3.1 The Evolution of Cost Management: From Factory to Front Desk

Cost accounting has its roots in the industrial revolution, designed to track tangible inventory. However, the "servicization" of the economy revealed the cracks in these old models. In the late 1980s, Kaplan and Cooper introduced Activity-Based Costing (ABC) as a solution to the changing cost structures of modern enterprises. They argued that managing "costs" is actually about managing the "activities" that cause costs to occur.

In the context of tourism, this evolution has been slower. The industry has historically relied on the Uniform System of Accounts for the Lodging Industry (USALI), which provides excellent departmental profit and loss structures but often fails to allocate undistributed operating expenses (like administration and marketing) to specific market segments.

## 3.2 Theoretical Frameworks

### 3.2.1 Traditional Costing Systems (TCS)

Traditional costing operates on a simple, two-stage allocation process. First, costs are assigned to departments. Second, they are applied to products using a single, volume-based driver.

- *The Logic:* If Product A sells twice as much as Product B, it must consume twice as much overhead.
- *The Flaw:* In tourism, volume does not equal complexity. A bus tour of 50 people (high volume) might require less administrative work than a VIP private tour for a couple (low volume). TCS fails to capture this, spreading costs like "peanut butter"—smoothly and evenly, masking the lumps of complexity.

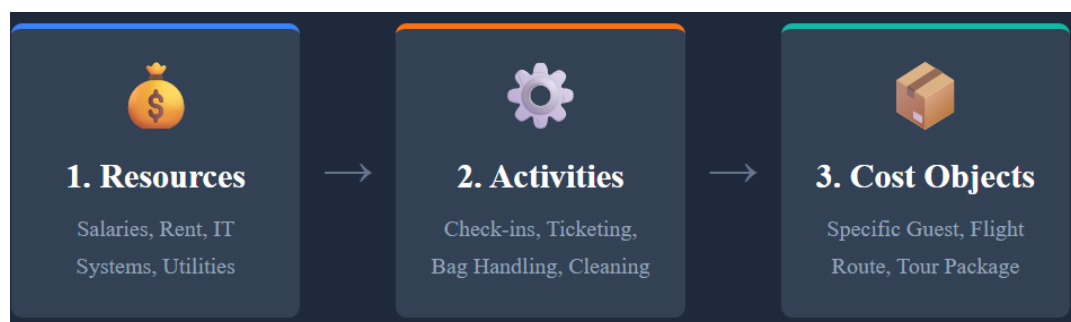
### 3.2.2 Activity-Based Costing (ABC)

ABC operates on a more granular premise: **Resources are consumed by activities, and activities are consumed by products (or customers).** The hierarchy of costs in ABC is vital for tourism:

1. **Unit-Level:** Costs incurred for each customer (e.g., laundry for one room).
2. **Batch-Level:** Costs incurred for a group (e.g., setting up a buffet, checking in a tour group).
3. **Product-Sustaining:** Costs to support a specific service line (e.g., maintaining the website for the "Eco-Lodge" wing).
4. **Facility-Sustaining:** General costs that cannot be traced (e.g., property taxes, general manager's salary).

#### The ABC Conceptual Framework

ABC operates on a simple premise: Products consume activities, and activities consume resources.



## 3.3 ABC in the Service Sector: Intangibility and Heterogeneity

Implementing ABC in tourism is distinct from manufacturing due to the unique characteristics of services:

- **Intangibility:** We cannot store "inventory" of hotel nights. If a room isn't sold, the opportunity is lost. This makes the *cost of capacity* a critical calculation in ABC.

- **Heterogeneity:** No two service experiences are exactly alike. One guest might ask the concierge for a restaurant reservation; another might ask for a helicopter charter. ABC attempts to capture this variance by assigning costs to the *activity* of "Concierge Requests" rather than just spreading the concierge salary across all rooms.
- **Inseparability:** Production and consumption happen simultaneously. The customer is part of the production process. A "difficult" customer literally costs more to serve. ABC is the only method capable of quantifying this "customer-induced cost."

### 3.4 Consumer Behavior and Cost Drivers

Academic literature links cost accounting directly to consumer behavior theories. The "Cost-to-Serve" model suggests that different behavioral segments impose different burdens on the firm.

- **The Transactional Customer:** Often price-sensitive, uses automated channels, requires little human interaction. (Low Cost-to-Serve).
- **The Relational Customer:** Values high touch, frequent communication, and customization. (High Cost-to-Serve).

The mistake many tourism businesses make is assuming that the Relational Customer is more profitable simply because they pay a higher rate. Without ABC, the firm cannot verify if the premium price covers the premium cost of service.

### 3.5 Strategic Cost Management (SCM) in Tourism

Strategic Cost Management (SCM) fuses cost information with strategic decision-making. It uses ABC data to answer questions like:

- Should we outsource our airport transfers or keep them in-house?
- Is the "All-Inclusive" package actually profitable, or does the unlimited consumption of food and beverage erode margins?
- Should we fire a customer? (A controversial but necessary question when ABC reveals negative profitability).

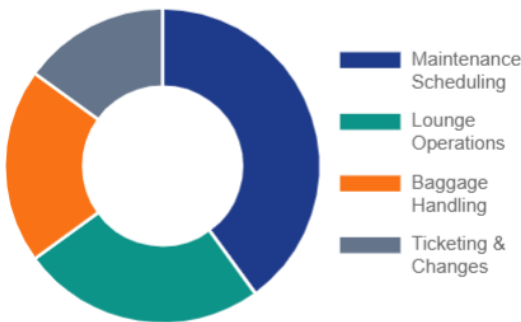
Application Across Sectors

How ABC reveals hidden costs in Airlines and Tour Operations.

Airlines



Airlines have massive overheads. ABC helps unbundle these costs. A "Frequent Flyer" who changes tickets 5 times and checks 3 bags may be less profitable than a standard economy passenger once activity costs are assigned.



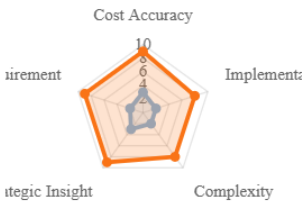
Tour Operators



The hidden cost of customization. A "Tailor-Made" trip requires hours of staff time (quoting, emailing) which eats into the margin compared to a standardized block booking.



Methodology Comparison



Goal: Relationships (Trade-offs)

Accurate Pricing

ABC allows businesses to unbundle services. Instead of raising room rates for everyone, hotels can charge specifically for high-cost activities like room service delivery or express laundry.

Activity-Based Management (ABM)

By identifying expensive activities (e.g., manual data entry for bookings), management can invest in automation to reduce waste and improve efficiency.

Customer Profitability Analysis

Not all revenue is good revenue. ABC identifies "high-maintenance" customers who consume disproportionate resources, allowing for strategic repricing or tier restructuring.

## 4. Methodology:

### 4.1 Research Design

This assignment employs a **quantitative descriptive approach** utilizing **simulated case modeling**. Given the proprietary nature of financial data in the competitive tourism sector, obtaining granular, activity-level ledgers from operating hotels is often restricted. Therefore, this study constructs high-fidelity simulation models based on industry averages, benchmarks from the *Horwath HTL Hotel Industry Studies*, and standard operational structures found in hospitality management literature.

### 4.2 Data Collection: Secondary Sources and Simulation

The "data" for this assignment is derived from two sources:

1. **Literature & Industry Reports:** To establish realistic cost categories (e.g., marketing, housekeeping, front office) and typical ratios (e.g., labor cost percentages).
2. **Case Simulation:** We created two distinct entities—"Hotel Azure" and "Summit Expeditions." For each, we generated a full year of hypothetical operating data, including general ledgers, activity logs (e.g., number of check-ins, hours of design time), and revenue reports.

### 4.3 Simulation Parameters

The comparison methodology involves running the same financial dataset through two separate algorithms:

- **Algorithm A (Traditional):** Allocates all indirect costs based on a single volume driver (e.g., Revenue or Room Nights).
- **Algorithm B (ABC):** Allocates indirect costs based on multiple cost drivers (e.g., number of bookings, design hours, customer inquiries).

The resulting discrepancy between Algorithm A and Algorithm B constitutes the "Findings."

## 5. Findings: Application of ABC in Tourism:

### 5.1 Case Study 1: The "Hotel Azure" Simulation

**5.1.1 Operational Profile** Hotel Azure is a 150-room upscale property. It serves two primary market segments:

1. **MICE (Meetings, Incentives, Conferences, Exhibitions):** Large corporate groups. They book months in advance, arrive in batches, and have a single master bill.
2. **FIT (Free Independent Travelers):** Individual leisure guests (couples, families). They book via various channels, arrive sporadically, and require individual billing and concierge attention.

### Financial Snapshot (Annual):

- Total Overhead Costs (Front Office, Reservations, Marketing): **\$1,200,000**

- Total Room Nights Sold: **40,000** (20,000 MICE / 20,000 FIT)
- Average Daily Rate (ADR): MICE (\$180) vs. FIT (\$200).
- *Note: On surface metrics, FIT looks more profitable due to higher ADR.*

**5.1.2 Traditional Costing Analysis** Under the traditional method, the hotel allocates the \$1.2M overhead based on **Room Nights**.

- **Allocation Rate:**  $\$1,200,000 / 40,000 \text{ nights} = **\$30 \text{ per room night.**}$

*Profitability Calculation (Simplified):*

- **MICE Segment:**  $\$180 \text{ (Rev)} - \$30 \text{ (Overhead)} - \$50 \text{ (Direct Cost)} = **\$100 \text{ Profit/Night**}$
- **FIT Segment:**  $\$200 \text{ (Rev)} - \$30 \text{ (Overhead)} - \$50 \text{ (Direct Cost)} = **\$120 \text{ Profit/Night**}$

*Conclusion (Traditional):* The FIT segment is the "star" performer. Management decides to shift marketing spend to attract more FIT guests.

**5.1.3 Activity-Based Costing Analysis** Upon closer inspection, the "Overhead" is actually composed of specific activities. We break down the \$1.2M into three cost pools:

1. **Reservations & Billing (Pool A):** Cost \$400,000. Driver: *Number of Bookings*.
  - MICE: 50 big bookings (1 booking = 400 rooms).
  - FIT: 5,000 individual bookings (1 booking = 4 rooms).
  - *Total Driver:* 5,050 bookings.
  - *Activity Rate:*  $\$400,000 / 5,050 \approx **\$79.20 \text{ per booking.**}$
2. **Check-in/Front Desk (Pool B):** Cost \$500,000. Driver: *Check-in events*.
  - MICE: 50 group check-ins (streamlined, keys pre-made).
  - FIT: 5,000 individual check-ins (10 mins each).
  - *Total Driver:* 5,050 events. (Assuming group counts as one batch event for admin purposes, or weighted lower). *Correction:* Let's assume weighted intensity. MICE batch check-in takes 2 hours; FIT check-in takes 10 mins x 5000.
  - Let's simplify: The cost driver is *hours of front desk time*. MICE consumes 200 hours. FIT consumes 2,000 hours.
  - *Activity Rate:*  $\$500,000 / 2,200 \text{ hours} = **\$227 \text{ per hour.**}$
3. **Guest Relations/Concierge (Pool C):** Cost \$300,000. Driver: *Requests*.
  - MICE: Minimal (schedule is set). 100 requests.
  - FIT: High demand (dinner reservations, tours). 2,900 requests.
  - *Activity Rate:* \$100 per request.

**5.1.4 Comparative Results: The "Hidden" Costs of Complexity** Now, we re-calculate the overhead allocation for the FIT segment:

- **Reservations Cost:** 5,000 bookings x \$79.20 = \$396,000
- **Front Desk Cost:** 2,000 hours x \$227 = \$454,000
- **Concierge Cost:** 2,900 requests x \$100 = \$290,000
- **Total ABC Overhead for FIT: \$1,140,000**
- **Total ABC Overhead for MICE:** (The remainder) = **\$60,000**

*Revised Profitability per Night:*

- **FIT Overhead per Night:** \$1,140,000 / 20,000 = **\*\*\$57.00\*\*** (vs \$30 traditional)
- **MICE Overhead per Night:** \$60,000 / 20,000 = **\*\*\$3.00\*\*** (vs \$30 traditional)
- **FIT Net Profit:** \$200 - \$57 - \$50 = **\*\*\$93.00\*\***
- **MICE Net Profit:** \$180 - \$3 - \$50 = **\*\*\$127.00\*\***

**Finding:** The traditional method was wrong. The MICE segment is significantly more profitable (\$127 vs \$93) despite the lower room rate. The complexity of managing thousands of individual FIT bookings, check-ins, and concierge requests consumes the vast majority of the hotel's resources. The hotel was unwittingly subsidizing FIT guests with MICE profits.

## **5.2 Case Study 2: "Summit Expeditions" Tour Operator**

**5.2.1 Product Mix: Standard vs. Bespoke** "Summit Expeditions" offers adventure tours.

- **Product A (Standard Group):** A fixed itinerary "Inca Trail" trek. 15 people per group.
- **Product B (Bespoke Private):** A customized itinerary for couples or families.

**5.2.2 The Cost of Customization** The company spends \$500,000 annually on "Operations Salaries" (Tour designers, vendor managers). Traditionally, this is allocated based on revenue. Since Bespoke tours cost more (\$5,000 vs \$2,000), they absorb more overhead, which seems fair.

However, an ABC analysis tracks the time designers spend:

- **Standard Group:** Once the itinerary is built, it is repeated 50 times a year.  
*Maintenance time: 50 hours/year.*
- **Bespoke Private:** Every trip requires new vendor calls, new maps, new guides.  
*Design time per trip: 10 hours.* If they sell 100 bespoke trips, that is 1,000 hours.

**5.2.3 Profitability Analysis** The activity analysis reveals that Bespoke trips consume 95% of the "Design Team" resources.

- **Gross Margin (Traditional):** Bespoke looks high margin (30%).
- **Net Margin (ABC):** After allocating the \$500,000 salary mainly to the Bespoke line, the net margin for Bespoke drops to nearly 5%, or even negative.

**Finding:** Summit Expeditions is essentially a "custom travel agency" masquerading as a tour operator. They are charging a premium for bespoke services, but not a *high enough* premium to cover the massive labor hours required to design unique trips. The Standard Group tours, which require almost no administrative maintenance, are the true cash cows.

## 6. Discussion:

### 6.1 Customer Profitability Analysis (CPA)

The findings from Hotel Azure and Summit Expeditions highlight the critical importance of CPA. In the tourism industry, the "Pareto Principle" (80/20 rule) is often cited—80% of revenue comes from 20% of customers. However, ABC often reveals a "Whale Curve" of cumulative profitability: the top 20% of customers generate 150% of the profits, while the bottom 20% (the high-maintenance, low-margin customers) actually *destroy* 50% of the value. ABC allows managers to identify these value destroyers. It changes the conversation from "How do we get more customers?" to "How do we get the *right* customers?"

### 6.2 Strategic Pricing: Moving Beyond Cost-Plus

Once the true cost of activities is known, pricing strategies can evolve.

- **Menu Pricing:** Instead of a bundled rate, hotels can unbundle services. The "budget rate" includes the room and automated check-in. The "premium rate" includes the concierge and flexible check-in. This is fair to the consumer and ensures cost recovery for the hotel.
- **Surcharges for Complexity:** Tour operators can implement "design fees" for custom itineraries. If a client wants to change their route three times, the ABC data justifies charging for the extra design hours, rather than absorbing it as "good customer service."

### 6.3 Operational Efficiency and Process Improvement

ABC is not just an accounting tool; it is a process map. By identifying that "Check-in" costs \$227 per hour of capacity in Hotel Azure, management is incentivized to innovate.

- **Digital Transformation:** Implementing mobile check-in or kiosks becomes a quantifiable ROI decision. If mobile check-in reduces front-desk activity by 30%, the savings are directly visible in the ABC model.
- **Vendor Consolidation:** For the tour operator, if "Vendor Negotiation" is a costly activity, reducing the number of suppliers to a preferred few reduces the negotiation activity and lowers costs.

### 6.4 Behavioral and Organizational Challenges

Implementing ABC is not without friction. It requires a cultural shift.

- **Resistance to Tracking:** Employees often view time-tracking (required for ABC) as surveillance. This can lead to lower morale or data manipulation.

- **Complexity Trap:** There is a danger of creating an ABC system that is too complex to maintain. A system with 500 cost drivers will collapse under its own weight. The goal is "approximate correctness" rather than "precise inaccuracy."
- **Solution - Time-Driven ABC (TDABC):** Kaplan's newer iteration, TDABC, simplifies this by using time equations. Instead of logging every minute, managers estimate standard times (e.g., "It takes 15 minutes to process a booking"). This is easier to maintain and update.

## 7. Recommendations:

Based on the critical analysis and case findings, the following comprehensive recommendations are proposed for tourism businesses:

1. **Implement a Pilot ABC Program:** Do not attempt to overhaul the entire accounting system overnight. Start with one department (e.g., Housekeeping or Banqueting) or one product line. Prove the concept by showing the cost differences between segments in that specific area.
2. **Adopt Time-Driven ABC (TDABC):** For service businesses, TDABC is superior to traditional ABC. Calculate the *Capacity Cost Rate* of your key resources (e.g., the cost per minute of a Reservation Agent). Then, assign time values to transactions. This is less intrusive and easier to update as processes change.
3. **Redesign Pricing Architectures:** Use ABC data to build "fences" around your prices.
  - *Hotels:* Differentiate rates not just by room view, but by service flexibility (cancellation policies, breakfast inclusion, payment terms).
  - *Agencies:* Introduce "Planning Retainers" for custom work that are credited against the final booking. This filters out "tire kickers" who consume design resources but don't book.
4. **Integrate with Technology:** Modern Property Management Systems (PMS) and CRMs collect vast amounts of data. Integrate these systems with the accounting software. If the PMS knows how many times a guest called the front desk, that data should automatically feed into the cost allocation model, reducing the manual burden of ABC.
5. **Train for Financial Literacy:** The marketing and sales teams must understand ABC. They are the ones negotiating contracts. If they understand that a "demanding" corporate client costs 20% more to serve, they will be empowered to negotiate a higher rate or a more streamlined service level agreement.

## 8. Conclusion:

The tourism industry stands at a crossroads. As consumer demands fragment and operational costs rise, the "business as usual" approach to financial management is becoming a liability. This assignment has argued that Traditional Costing Systems, with their reliance on volume-based averages, create a fog that obscures the true drivers of profitability. They reward revenue volume even when that volume destroys value.

Activity-Based Costing offers a path through this fog. By tracing costs to the specific activities of check-in, customization, cleaning, and coordination, ABC aligns the financial picture with the operational reality. The case studies of *Hotel Azure* and *Summit Expeditions* demonstrated that high-touch, customized services often carry a "complexity tax" that erodes margins—a fact invisible to traditional accounting.

While the implementation of ABC requires effort, data discipline, and change management, the strategic rewards are immense. It empowers tourism managers to price with confidence, optimize processes with precision, and allocate resources where they truly generate wealth. In the modern experience economy, knowing the price of everything is not enough; one must know the *cost* of everything. ABC provides that knowledge.

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