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American Institute of Accountants. Bureau of Information

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Accounting Questions

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APPORTIONMENT OF GENERAL EXPENSES TO THE TELEPHONE DEPARTMENT OF A HOTEL

Question: In furnishing telephone service to their guests, hotels act as agents for the telephone companies. To determine whether hotels obtain just compensation on their telephone sales it seems logical that not only direct departmental expenses such as payroll and telephone company bills should be included as costs of the hotel telephone department, but that indirect expenses should also be considered. As the determination of the direct expenses presents no difficulties, the problem of ascertaining the telephone costs resolves itself into one of cost accounting: What share of the general expenses of the hotel should be charged to telephone sales?

The principal revenue-producing departments in a hotel are rooms, food, telephone, valet, and laundry. In addition to the direct expenses incurred for the benefit of these departments, there are in every hotel certain general expenses such as:

Salaries of manager and his assistants, expenses of manager and his assistants, including association and club memberships, traveling expenses, books and technical magazines. General publicity and advertising for the purpose of bringing guests to the hotel. The guests spend money in one department or more.

Answers to the following questions are desired:

1. Is it proper to apportion to all revenue-producing departments such general expenses as listed above?
2. If the answer is yes, what should be the basis for apportioning the expenses? Should it be the sales?

The doorman, room clerks, information clerks, bellboys and elevator operators in a hotel are all employed for the purpose of receiving and serving guests. Should the salaries of these employees, plus their sundry expenses, and the value of the space occupied by them, be apportioned among the revenue-producing departments, in which guests spend money, and if so, on what basis?

This entire problem is not one for hotel accountants to solve, but one for cost accountants. The answer should not be based on what the present accounting practice is but on what the practice should be in order to follow good cost-accounting procedure. There is no intention at present of attempting to apply the method of apportioning general expenses regularly in the preparation of hotel reports, the idea being only to make tests to determine whether the telephone departments are profitable or not after taking into consideration all proper expenses.

Answer:

DEFINITIONS

It will be helpful to re-state the proposition:

Direct departments. There are certain revenue-producing departments in a hotel, such as rooms, food, telephone, valet and laundry. The sales in these departments can be identified. Such departments are referred to as direct departments.

Indirect departments. There are other departments in a hotel (in which sales are not made or from which revenue is not immediately obtained) that are necessary to the operation of the establishment. Examples of such departments are administration, namely, salaries of manager and his assistants; general publicity and advertising; doormen; information clerks; bell boys; elevator operators; front office; auditing department; etc. These are referred to as indirect departments.

Direct expenses. Certain expenditures for materials, supplies, salaries and wages needed for the operation of direct departments can be identified with specific departments. These are referred to as direct expenses.

Indirect expenses. Many other expenditures, principally connected with the operation of indirect departments, can not be immediately applied to direct departments, but as a rule can be classified under the indirect departments to which they relate. These are referred to as indirect expenses.

QUESTIONS

1. Should indirect expenses be sub-divided and charged to direct departments?
2. If so, on what basis should the indirect expenses be distributed?

ANSWER

1. It is a good principle in cost accounting to refrain from distribution of indirect expenses whenever there is a choice as to procedure. The difficulties which arise in the attempt at distribution of the actual expenses are, first, the practical impossibility of finding an actual basis for their distribution and, secondly, the confusing results in operating statements for direct departments when numerous and different indirect expenses are introduced on varying and usually fluctuating bases. If, for example, it is attempted to charge the telephone department for proportions of management expenses, attendants' expenses, auditing expenses and the like, the operating costs of the telephone department will be affected by at least two variables, namely, the basis of apportionment and the amount of expense. If the telephone costs are carried a step further and reduced to unit costs per call, the result is most confusing because of the introduction of additional variables, such as the number of calls made, the revenue collected and the direct expenses.

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The preferable procedure would be to set up accounts for the indirect departments, using as many accounts as there are clearly distinguishable activities of sufficient importance. The actual expenses should be charged to these accounts.

As steps preliminary to this procedure, two budgets should be established. One budget should be set up for the direct departments containing estimates of sales or revenue and corresponding direct expenses. The other budget should be set up for the indirect departments, containing estimates of the expenses deemed necessary for operating the establishment as a whole with regard to the expected activities in the direct departments.

The budget of indirect expenses should be reduced to normal expense rates and distributed upon some equitable basis between the direct departments. Normal expense rates are thus derived for indirect expenses, by means of which they may be carried into the operating accounts of the direct departments with the minimum of variability.

Under this procedure, the operating statement of the telephone department would show: (a) revenue, less (b) direct expenses and (c) normal indirect expenses, leaving (d) profit or loss. Telephone costs would be calculated for the purpose of ascertaining whether just compensation was being received on the basis of the budgeted direct and indirect costs. The calculations can be modified by appropriate ratios if it develops there are substantial and consistent differences between budgeted and actual amounts.

Any balances remaining in the indirect-expense accounts, after the absorption of normal expenses, would constitute over- or under-absorbed expenses. Such variations are not attributable to the operation of direct departments but more nearly to the obtainment of business for them. An unabsorbed expense is comparable to the unabsorbed expense in a factory, which is due, not to ineffectiveness in manufacture, but to lack of orders enough to fill manufacturing capacity.

Another advantage of this procedure worth mentioning is that a comparison is possible as to indirect expenses between actual expenses and the normal budget on the one hand and absorbed normal expenses and the budget on the other. The spending ratio must be kept in line with the absorbing ratio or a loss will ensue.

2. As to the basis to be used in distributing the indirect expenses in the budget, it is difficult to generalize, unless it be to the point that sales are likely to be an unsatisfactory basis. The indirect expenses do not run with sales. They vary according to (a) degree of service rendered and (b) time. Therefore the normal expense rates should be brought to a basis of so much per diem, modified by degree of use. That is to say, the main restaurant would be charged more than the grill room, and the grill room perhaps more than the coffee shop. In setting these differentials, the respective sales levels might be given some weight. Or, the indirect expenses applicable to rooms should be reduced to rates per room-day, with differentials for single rooms, double rooms, suites, etc.

In some cases this application of indirect expenses, by means of normal rates, will result in fixed charges per diem, irrespective of activity in the direct department. This will be equitable, because the indirect expenses will be the same for the restaurant, as an example, whether 100 or 800 people are served. In other cases, as with room-day rates, the absorption of normal expenses will vary with occupancy, in this way following activity.

It should be understood that other bases might be necessary, but the general principles above mentioned—that they should reflect (a) degree of use and (b) time—should still govern.

In conclusion, it may be stated that the answers given above are made without regard to existing practice in hotels, as was requested in the inquiry. They follow the principle of modern cost-accounting practice in industry, developed with the use of standard costs.