## BUDGETING

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## INTRODUCTION

The most important long-term planning function performed by front office managers is budgeting front office operations. The hotel’s annual operation budget is a profit plan which addresses all revenue sources & expense items. Annual budgets are commonly divided into monthly plans, which, in turn, are divided into weekly (& sometimes) daily plans. These budget plans become standard against which management can evaluate the actual results of operations.

**Budget is a planned financial statement of intended expenditures for a given period of time in future for the projected revenues during the period covered.**

The budget planning process requires the closely coordinated efforts of all management personnel. While the front office manager is responsible for room revenue forecasts, the accounting division will be counted on to supply department managers with statistical information essential to the budget preparation process. The accounting division is also responsible for coordinating the budget plans of individual department managers into a comprehensive hotel operations budget for top management’s review. The hotel general manager & controller typically review departmental budget plans & prepare a budget report for approval by the property’s owners. If the budget is not satisfactory, elements requiring change are returned to the appropriate division managers for review & revision.

The primary responsibility of the front office manager in budget planning is forecasting rooms’ revenue & estimating related expenses. Rooms’ revenue is forecasted with input from the reservations manager; expenses are estimated with input from all department managers in the rooms division.

The hotels annual operation budget is a profit plans that addresses all revenue sources & expense items. Budgets are important tools for managing cash flow, controlling costs, and making effective management decisions. The ability to accurately predict future profits requires a firm understanding of operating costs.

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**Types of Budgets**

Budgets are of various types and based on the purpose for which they are prepared, these may be classified as follows:

1. **Fixed Budget** : A budget which is independent of the level of turnover is known as fixed budget. It is based on one set of condition, one volume of output and simple collection of cost.Eg. advertising budget, office administrative budget, maintenance budget.
2. **Flexible Budget** : A budget which may change with the changed circumstances and conditions is called a flexible budget. It contains different estimates in different assumed situations. Eg. Labour Budget
3. **Long Term Budget** : A budget which is prepared for a long period of time which could be 1 to 5 years is known as long term budget. Eg.Capital Budget
4. **Short Term Budget** : A budget which is prepared for a short period which is less than one year like monthly, weekly or daily is known as short term budget. Eg.Seasonal Budget
5. **Capital Budget** : A capital budget is prepared for the addition or acquisition of fixed assets for the organization.Eg. acquisition of land, building or expansion plans. Investment in property, buildings and major equipment are part of capital expenditure. The magnitude and duration of these investments can justify the creation of separate budgets for such expenditures.
6. **Revenue Budget** : Revenue budgets are forecasts of a company's sales revenues and expenditures, including capital-related expenditures.
7. **Cash Budget** : An estimate of a company’s cash position for a particular period of time. Cash budgets are forecasts of how much cash the organization will have on hand and how much it will need to meet expenses, This budget can reveal potential shortages or the availability of surplus cash for short term investments.
8. **Operating Budget** : A business’s forecasted revenue along with forecasted expenses, usually for a period of one year or less.

Operating Budget may include :

* **Sales Budget** : An estimate of the quantity of goods and services that will be sold during a specific period of time and the amount of revenue that can be generated from the sale.
* **Labour Cost Budget** : Labour costs are budgeted in relation to the budgeted volume of sales. Labour budget gives the estimate of labour requirements to meet the production needs during the budgeted period. The budget includes both direct and indirect labour requirements in most cases.
* **Selling and Distribution Cost Budget :** This budget forecasts the cost of selling and distributing products during the budget period. It is based on sales budget in that sales estimated point to the cost to be incurred in selling and distribution. This budget is jointly prepared by the sales manager, the advertising manager and distribution manager.
* **Production Cost Budget :** It details the estimated cost of carrying out production plans as per the production budget. It breaks up the cost of each product into 3 main elements – material, labour and overhead
* **Purchase Budget :** Purchase budget shows the purchase to be made during the budget period. In some cases, a purchase budget may deal with the purchase of raw materials only while in other cases, it may incorporate the purchase of all direct and indirect material as also fixed assets and services like electricity, gas etc
* **Overhead Cost Budget:** Estimate on the expenses on overheads like administration cost, office expenses, gas and electricity, advertising’. . Includes :

Rent

Gas and electricity

Postage and telephones

Printing and stationary

Interest payable

Legal fees

Advertising

1. **Zero based Budget :** Zero-based budgeting (ZBB) is a method of budgeting in which all expenses must be justified for each new period. The process of zero-based budgeting starts from a "zero base," and every function within an organization is analyzed for its needs and costs.  Zero-based budgeting starts from zero, rather than a traditional budget that is based on previous budgets. With this budgeting approach, you need to justify each and every expense before adding it to the actual budget. The primary objective of zero-based budgeting is the reduction of unnecessary cost by looking at where costs can be cut.

The advantages of zero based budgeting are :

**Efficiency**: Zero-based Budgeting helps a business in the allocation of resources efficiently (department-wise) as it does not look at the previous budget numbers, instead looks at the actual numbers

**Accuracy:** Against the traditional budgeting method that involves mere some arbitrary changes to the earlier budget, this budgeting approach makes all departments relook every item of the cash flow and compute their operation costs. This methodology helps in cost reduction to a certain extent as it gives a true picture of costs against the desired performance.

**Budget inflation:** As mentioned above every expense is to be justified. Zero-based budget compensates the weakness of incremental budgeting of budget inflation.

**Coordination and Communication:** Zero-based budgeting provides better coordination and communication within the department and motivation to employees by involving them in decision-making.

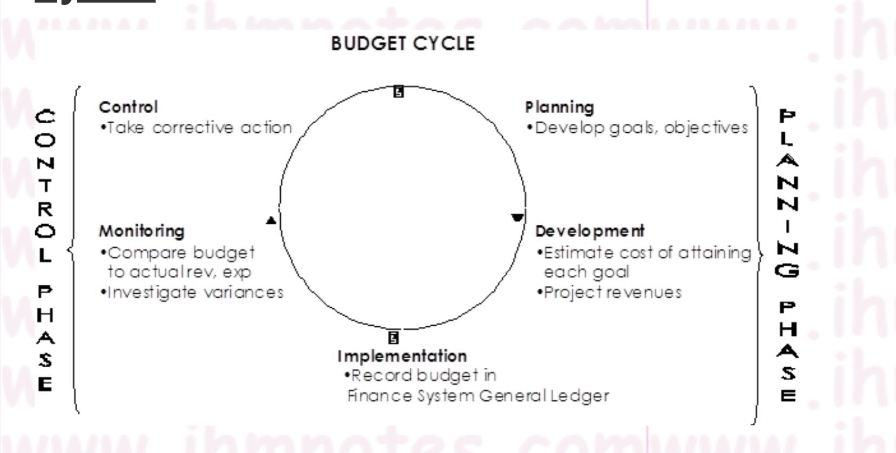
**Reduction in redundant activities**: This approach leads to identify optimum opportunities and more cost-efficient ways of doing things by eliminating all the redundant or unproductive activities

**The Budget Cycle**

The budgeting process is a cycle comprising of two main phases : **the planning phase and the control phase.** **The planning phase** identifies the goals to be attained during the fiscal year and the financial plan or budget necessary to achieve them. The budget must be well conceived and based upon a combination of historical data and future financial projections. During this step of the budget cycle, employees who handle the day to day finances for a department are offer asked to provide information to management about the past and anticipated revenues and expenses.

The **control phase** focuses on actual performance towards achieving the plan. It involves implementation, monitoring and control functions. The control phase emphasizes a comparison between the budget and the actual revenue and expense activity as recorded in the Finance System and displayed on the monthly statements. When actual revenue and expenses vary from the budgeted ones, the control phase will then include corrective action. Corrective action might involve adjusting the budget to reflect the actual financial activity, adjusting revenue projections or adjusting expenditures.

The following diagram illustrates the budget cycle:



**Making of Front Office Budget**

Front Office is one of the major revenue producing departments of a hotel and is responsible for guest satisfaction. Approximately 70% or even more of revenue is generated from this department, so it becomes all the more necessary that more than any other department a more conscious budgeting / budgetary control is exercised on this department. Front Office department of a large hotel has various sections such as Reservations, Lobby, Bell desk, telephones etc. The Department Master Budget of Front Office, which includes budgets for each section such as Reservation, Lobby and Bell Desk individually.

Reservation section will give its budgeted figures of reservation for a specific period of time (number of bookings). This budget will also include the cost of reservation system, ie. Cost to be incurred on various equipment and stationary used in the system, for eg. Reservation rack, their replacement, new purchase, maintenance etc. Also the cost incurred on stationary like reservation slip, Shannon slip etc. Similarly if it is on computer system, then the cost incurred on maintenance and repair of computer hardware or if a new machine needs to be procured. Further the reservation budget may include the budgeted figure of labour which will consist of

* the requirement of staff
* labour cost and labour related cost for that period

The budget for the reservations section will be prepared by the reservations manager with input from his staff.

On similar lines, sub section budget shall be prepared by other sections of Front Office, such as Lobby and Bell Desk. Many hotels combine the bell desk budget with the lobby budget. These budgets are also made on the lines of fixed or static budget, sales budget and operating expense budget and labour and labour related expense budget etc. The lobby budget is usually prepared by Lobby manager, who is assisted by the Bell Captain

Finally on the basis of the sub section budgets, the Front Office Manager prepares a Front Office department budget for the hotel. Normally the Front Office budget is prepared on a quarterly basis. While preparing the budget, guidance is taken from past figures and information. The marketing and sales department of the hotel also helps in preparing the final budget as they can also forecast the future business. The budget has to be given to the department for implementation once it is approved by the Front Office Manager, then by the General manager, The Financial Controller and then by the Board of Directors.

Heads under Front Office Budget:

Fixed Cost : Racks, tables, Computers, front office equipment etc.

Operational Cost : Printing and Stationary, Travel agents commission, salaries and wages, Transportation, Telephone calls, overheads.

Once the budget has been given for implementation, any deviations must be observed, recorded and notified. From time to time the refining of the budget must also be done.

***Forecasting Room Revenue***

Historical financial information often serves as the source on which front office managers build rooms revenue forecasts. One method involves an analysis of room revenue from past periods. This means the Reservation Manager will supply to the Front Office Manager figures of room revenue for, say, three previous years and the pattern in the increase of revenue and also the increase in terms of percentage.

Another approach to forecasting room revenue bases the revenue projection on past room sales and average daily room rate

Forecasted Room Revenue = Rooms Available X Occupancy % X Average Daily Rate

A more detailed approach would consider the variety of different rates corresponding to room types, guest profiles, days of the week and seasonality of business and several other factors affecting room revenue.

##### Example I

#### Rooms’ revenue summary for the Star Dust Hotel

#### 

|  |  |  |
| --- | --- | --- |
| **Year** | **Room Revenue** | **Increase of 15% per year** |
| 2017  2018  2019  **2020** | Rs 50000000  Rs 57500000  Rs 66125000  **Rs.76043750** | Rs 7500000  Rs 8625000  **Rs. 9918750** |

The above data shows yearly increase in net room revenue for the hotel. Every year there is a 15% increase in room revenue. In future, if conditions appear to be similar to those of the past, the room revenue for 2020 would be budgeted at Rs. 76043750, a 15% increase over 2019 amount.

**Sales averages**

Past financial information is called historical data. The more recent the historical data used, the more accurate the average. In most cases, sales figures from more than three years in the past often are not reliable for predicting future sales. To calculate an average, add the amounts and divide the sum by the number of amounts.

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Year** | **Total no. rooms in the hotel** | **Occupancy %** | **No. of rooms sold during the year** | **Total revenue for the year (in Rs)** | **ARR** |
| 2016  2017  2018  2019  **2020** | 120  120  120  120  **120** | 70  73  74  75  **76** | 30660  31974  32412  32850  **33288** | 30660000  33252960  35004960  37449000  **39945600** | 1000  1040  1080  1140  **1200** |

Another approach to forecasting room revenue is based on the revenue projection on past room sales and average daily rooms sale. Above statistics is of a hotel which has 120 rooms. The table shows the occupancy percentage increased by 3% in 2017, 1% in 2018 and 1% in 2019. Average daily room rate increased by Rs,40, Rs.40 and Rs.60 respectively over same periods. Considering the future conditions to be similar, a room revenue forecast of 2020 may be based on a 1% increase in occupancy percentage (to 76%) and Rs.60 increase in the average daily room rate (to Rs.1200). Given these projections, the following formula can be used to forecast room revenue for the following year:

Forecasted Room Revenue

Rooms Available X Occupancy % X Average Daily Rate

(120 X 365) X 76 X 1200

100

Rs. 39945600/-

This simplified approach to forecasting room revenue is intended to illustrate the use of trend data in forecasting. A more detailed approach would consider the variety of different rates corresponding to room types, guest profiles, seasonality of the business etc.

**Projecting Expenses**

Most expenses for front office operations are direct expenses in that they vary in direct proportion to room revenue. Historical data can be used to calculate the approximate percentage of room revenue that each expense item may represent. These % figures can then be applied to the total amount of forecasted room revenue, resulting in rupee estimate for each expense category for the budget year. Typical rooms division expenses are payroll and related expense, guest room laundry, guest room supplies, stationary, travel agents commission, reservation expense and other expenses.

One key element in budget preparation is the estimating/projecting expenses. Since expenses are categorized both in relation to operated departments (direct/indirect) and how they react to changes in volume (fixed and variable), the forecasting of expenses is similar to the approach used in forecasting revenue. However, before department heads are able to estimate expenses, they must be provided with information regarding the following:

Expected cost increases for supplies and other expenses

Labor cost increases, including the cost of benefits and payroll taxes.

Expenses are of two types: **fixed expenses and variable expenses**. A fixed expense remains constant and is not dependent on sales and these include charges such as depreciation, insurance expense, property taxes, rent expense, and similar expenses. A variable expense fluctuates as sales rise or decline. Expenses such as stationery charges, room amenities expense that varies as per the occupancy of the establishment are termed as variable expenses.

Examples of Operational Expenses in Rooms:

* Salaries and wages
* Laundry
* Guest Supplies
* Printing and Stationary
* Travel Agents Commission and Reservation Expenses
* Transportation
* Training
* Uniforms
* Telephone calls
* Overheads

**Factors affecting Budget Planning**

The following are the elements, which affects the front office budget planning.

* **Accommodation:** This is one of the most critical key factors operating in hotels. When all the rooms are sold, it is impossible to increase the volume of room sales except through an increase in room rates. When the sales budget is being prepared it is essential to examine patterns of occupancy to establish what level of room sales may realistically be expected during the forthcoming budget year. Where there is a high degree of room sales instability, evidenced by pronounced swings in occupancy rates, it is desirable to examine the possibility of shifting demand from peak to off-peak periods.
* **Shortage of labour:** This particular key factor is potentially powerful, but there is no evidence that it exerts much influence on the volume of hotel and restaurant sales. In some locations, labour shortages may, in fact, be a severe limiting factor.
* **Consumer demand:** Consumer demand is often found to be a potent key factor. Its operation may be due to several reasons.
* The price level of the establishment may be too high, and this may result in a low ARR or low occupancy or both**.**
* **Quality of management:** The management and its operation however do not have a bearing over short period. Over longer periods, the quality of management will have a direct and powerful influence on the volume of sales generated.
* **Other factors:**

Political state of affairs

Natural calamities

Terrorist activities

Climate conditions

Events (sports, festival celebration, etc)

Importance of the city (climate, industries- IT, BPO, Biotechnology)

**Refining Budget**

The term ‘refining budget’ can also be called as amending the budget, or adjusting the budget or modifying the budget. This means ‘to change’ which may be increasing or decreasing the figures of the already prepared forecasted figures. Budget is a forecast for future based on certain assumptions. Whatever base was taken for these assumptions may occur or may not occur at all or may occur partly or more than the expectations, and hence the actual figures may be more or less than the projected figures. Budget should be monitored at regular intervals and variances ( may be plus or minus) have to be studied and analysed immediately and corrective action taken. Reforecasting is normally suggested when actual operating results begin to change significantly from the original budget. Refining budget is a very important activity and it protects the establishment from suffering a loss. If we are not able to meet the targeted revenue, then the expenditure part also needs to be scaled down proportionately, failing which money may be wasted unnecessarily. The refining of budget is done by the same person who initially prepared the budget, but he must be furnished with facts and figures, data and information through the Management Information System (MIS).

**Budgetary Control**

It is the financial control through budgets, which means fixing responsibility for budgeted results to the managers concerned. It is a control technique because it provides a standard for evaluation of actual performance. Hence budgetary control means the responsibilities we assign to managers, usually expressed in terms of items such as sales targets, profit margins and cost ceilings. Budgetary control is the process of finding out what is being done and comparing actual results with the corresponding budget data in order to approve accomplishments or to remedy differences by either adjusting the budget estimates or correcting the causes of differences.

Another aspect of budgetary control is perpetual comparison of budgeted figures to actually achieved figures of the business for that specific period for which the budget was prepared. Variances are ascertained. Where there is a system of budgetary control in operation, current operating results are viewed frequently, weekly, monthly or quarterly. Budgetary control has been defined as the establishment of budgets relating to the responsibilities of the executives to the requirement of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objective of that policy or provide a basis for its revision.

**Objectives of Budgetary Control**

The objectives of budgetary control may be summarized as follows:

* To give a practical expression to the aims and objectives of the business
* To provide a detailed plan of the Front Office Operations with respect to a particular trading period
* To ensure better cooperation of various departments / sub departments.
* To set ‘benchmarks’ against which the managerial performance is to be measured
* To ensure an economical use of the resources of the business
* Budgeting serves to clarify the programme, measure efficiency, and provide definite plans to all concerned
* Essentials of Sound Budget
* To be effective, a budgetary control system should be based on the following guidelines:
* Define clearly the responsibilities and authorities for preparation and administration of budget
* Sound organizational capabilities
* An accurate and adequate system of measuring and recording performance. The budget making must receive a total support of top management.
* Timely and regular system of reporting of current events should be developed to keep responsible people informed of actual results for timely correction. There must be an effective accounting and costing system.
* Clearly defined policies should be established for all phases of the firm.
* Free and frank communication between different departments and members of the organization through regular meetings of budget committee. All levels of staff must understand and support the system. All managers expected to administer and live under budgets must have a part in their preparation, so that they understand the budget and are loyal to them
* Efficient forecasting and research is necessary for the formulation of realistic budgets. Sufficient time should be allowed to obtain desired results from budgeting. The budget period should be appropriate to the nature of the firm.
* Human factor is very important in budgeting. Due credit should be given for the job well done. Persons unable to achieve budgeted results should be held accountable. Budget should be designed only as tools and not to replace management. Budget should not be overdone to seriously compromise the authority of managers.
* The system should be designed to meet the needs and conditions of the particular enterprise. Proper flexibility through alternative budgets, regular revisions etc. and effective follow up are important aspects of sound budgeting.
* Key to effective budgeting is developing and providing standards, by which a manager’s work can be translated into needs for manpower, material, money and other resources.
* Budgetary control should not be used in situations where other control systems are more suitable.

**How budgetary control is applied:**

Budgetary control is enforced to accomplish the goals and objectives of the hotel. For this it is important to follow the course of action that would make the realization of budgeted targets possible . Whenever the manager finds that there is deviation in actual from the budgeted target, he must immediately find the cause and promptly decide and implement the corrective action to set those deviations right.

**Essentials of effective budgetary control**

* Quick Reporting: Juniors who are actual operators are required to submit a performance report immediately to their boss. Further, these reports must be analysed quickly on the basis of the past data and other available information for quick remedial action to be taken.
* Seriousness in implementation: The top management should take the budget seriously. Only then will the juniors have a sense of seriousness.
* Responsibility matched by authority: Those who have been made responsible to accomplish the budgeted targets are given appropriate authority to do so.
* Rewards and Punishments: As per the performance, the employees must be suitably awarded, appreciated or punished.
* Flexibility: There should be no hesitation in changing / modifying or refining the budget from time to time as per the current need which will be broadly dependent on business conditions and various other factors. But at the same time, budget figures should not be altered too much or too often.
* Have Patience: It always takes time to show results. Hence budget should not be modified too early without any sensible reason.

**Advantages of Budgetary Control**

Some of the advantages of budgetary control are as follows:

* Eliminates uncertainty: It provides a planned approach to every activity of hotel within which expenses have to be incurred and results achieved. This eliminates uncertainty and ensures that the hotel is not caught unawares in the face of actual situation.
* Result of various brains: The involvement of top management brains in making the budget ensures that budgets are not framed according to subjective standard and a single individual.
* Good incentives to workers at times: High standard budgets at times provide incentives to employees to work towards it.
* Optimum use of Capital resources: It guides the hotel to use its capital resources in a most profitable manner.
* Easy availability of working capital : The cash receipts and expenses budget ensures that sufficient working capital and other necessary resources for efficient functioning of the business are available.
* Effective co-ordination: Budgeting makes co-ordination between various departments more effective as the goals of each department are interlinked with the other for the achievement of the hotel goal in totality.
* Responsibility can be pin pointed
* Spotlight on deviation : Deviations can be pinpointed and areas of weakness can be discovered and suitable corrective action can be taken to bring the performance to required standards
* Optimum utilization of man, machine and material : Budgeting aims at distributing production programme according to production capacity and makes most effective utilization of men, material and machine.
* Serves as a beacon light: Budgeting provides a benchmark for actual performance and shows the path to achieve the standards.

**Limitations of Budgeting:**

* Budgets are estimates and can never be 100% accurate. They are only as good as the data and forecasts on which they are based. Inflation and rapid changes in business environment tend to distort budget data before they are put into operation.
* The budget is simply a tool to efficient management and not a substitute for it. An efficient system of budgeting can achieve nothing without effective planning and control
* Budgets cannot guide as to what action should be taken
* Sound system of effective supervision is necessary and the lack of it would make the budget ineffective
* Budgeting entails the danger of inflexibility as everyone becomes conscious that they must adhere to the projected budget, otherwise they will be called inefficient. The budget is not something that has to be adhered to under all conditions but a measure of performance and a guide which should be adjusted to meet new situations.
* Budgets may be misused by managers to find fault with their employees and restrict performance rather than improve it.
* The initiative and creativity in an employee may be hampered if the supervisor and managers stick to budget strictly.
* Budgeting is a time consuming process and involves expenses. There is a tendency of going into excessive details which restricts freedom of action.
* Budgeting goals may lead people to supersede the enterprise goals. Budgeting may be used to hide inefficiencies as past practices become evidence for the present. There is also the need to safeguard against overemphasis on factors that happen to be easier to observe.
* Success of budgeting depends on the motivation of people who are to install and use budgets.
* Budget making is a tempting exercise. It provides an opportunity to grapple with situations that are yet to arise. Budget making can be effective only when there is some correlation between the cost of the system and the benefit to be derived from it. (Lack of cost benefit analysis)
* Budgeting is but a means to an end, the end being the successful achievement of budgetary targets. However, this is not always the case. It is too often assumed that introduction of a budget programme by itself is not enough to guarantee its successful execution.
* Although budgeting is a big help in arriving at proper decisions, very often it is seen as a substitute rather than as a tool of management. If, taking cover under budgeting, the management, whose job is to choose the best among the alternative courses of action, turns a blind eye to its responsibility of decision making, then the situation may lead to harmful consequences for the business.

**Suggested reading**

* Principles of Hotel Front Office Operation – Sue Baker, Jeremy Huyton, Pam Bradley
* Hotel Front Office Management: James A. Bardi
* Managing front office operations: Michael L. Kasavana, Richard M. Brooks
* Back office operations and administration: Dennis L. Foster