

Hotel Online Special Report

Zero-Based Budgeting in the Hospitality Industry

By Jose Acosta, August, 2006

As we enter the 2007 budget season many individual hotels and hotel companies will present to their owners or asset management team a budget package that has revenues detailed by day and expenses detailed by month. In some cases the operating expenses will be prior year expenses increased by a reasonable CPI index and in other cases will be just straight lined by month. Some of the budget presentations will have explanations on fixed expenses; however, they will lack detail explanation of the rationale of each expense. Also as labor cost continues to be a major concern, some productivity analysis will be presented; but most companies will still lack detailed explanation on how the single largest expense will be managed as well as a detail explanation on productively improvements.

Today's hotel companies are more competitive and dynamic than ever before. As a result, the days when hotel budgeting was merely a routine process of incrementally increasing the prior year revenues and expenses have long ended. Successful hospitality companies are constantly seeking ways to improve their ability to predict future operations and related resource requirements, enabling them to adjust their budget plans as needed to stay ahead of the competition. Not only does this alter the importance of the budget and forecast process; but, it also changes the traditional methods used of incremental, fixed and flexible budgeting processes.

The hospitality industry's traditional method of budgeting revenues and expenses has been the same for decades. Up to now, the most commonly used methods have been

Incremental Budgeting and Fixed or Flexible Budgeting.

Incremental Budgeting: this method is widely used in the hospitality industry and generally entails budgeting revenues and expenses based on the prior period adjusting for inflation by a percentage.

Fixed and Flexible Budgeting is usually for one specific expense item that is referred to as 'fixed'. A budget adjusted for a change in the level of activity is called a 'flexed' or 'flexible' budget, which means that when the level of activity changes, it is expected that the total of all costs will change. Information about how each type of cost behaves is related to how income enables budgets to be adjusted for different levels of activity. If actual results are to be compared with budgets for the purposes of performance measurement - for example, cost per occupied room, percentage of expenses, etc. - such adjustments would be necessary to ensure the comparison is reasonable.

Hotels most often budget simply by increasing the Key Performance Indicators (KPI) by a targeted percentage or by a given CPI index on a monthly basis, and then calling it a day without any of the necessary detailed explanations to support these expenses. Such budgeting and forecasting methods have created a tremendous short fall in future projections that put owners in a difficult situation when confronted by investors and lenders.

Over the past few years, however, tremendous technological improvements have been made to enhance revenue budgeting tools. There are now a few revenue yield management systems available to improve ADR, market penetration and RevPar. This has helped many hospitality companies improve market share, penetration and hotel positioning in each market. So it would also seem that with all the new technology available it should be easy for hoteliers to use the more informative Zero Base Budgeting method.

ZERO BASE BUDGETING

Zero based budgeting derives from the idea that such budgets

are developed from a zero base; that is, at the beginning of the budget process, all budget accounts have a value of ZERO. This is in sharp contrast to the incremental budgeting system where generally a new budget tends to start with a balance at least equal to last year's total balance, or an estimate of it.

Objectives

The goal of preparing a zero base budget is to achieve an optimal allocation of resources that incremental and other budgeting methods are less likely to present. Zero Based Budgeting starts by asking managers to identify and justify their area(s) of work in terms of business volumes.

Zero Based Budgeting forces managers to justify their work by saying to them that unless and until they put forward a budget that more senior management can support, at least to a large extent; then the budget will not be approved. If Zero Based Budgeting is applied as literally as it is designed, then unjustified work and expenses would simply stop.

An effective zero base budgeting system benefits organizations in several ways. It will:

- Focus the budget process on a comprehensive analysis of objectives and needs
- Combine planning and budgeting into a single process
- Cause managers to evaluate in detail the cost effectiveness of their operations
- Expand management participation in planning and budgeting at all levels of the organization

Zero Based Budgeting process has a lot to offer it in terms of the way it forces management at all levels of an organization to become involved in the budgeting process. Zero Based Budgeting is built on the concept that what one expects in the future will be dependant on the ability to persuade the rest of the management team that it is deserved; that is in summary, justify nothing and you'll get nothing!

Advantages of Zero-Based Budgeting

1. Results in efficient allocation of resources as it is based on needs and benefits.
2. Drives managers to find out cost effective ways to improve operations.
3. Detects inflated budgets.
4. Useful for service department where the output is difficult to identify.
5. Increases staff motivation by providing greater initiative and responsibility in decision-making.
6. Increases communication and coordination within the organization.
7. Identifies and eliminates wastage and obsolete operations.

Disadvantages of Zero-Based Budgeting

1. Forced to justify every detail related to expenditure.
2. Difficult to implement using spreadsheets (would require a database application to be most effective).
3. It is very time-consuming if justification sheets are done using spreadsheets.
4. Necessary to train managers on the concept. Zero Based Budgeting should be clearly understood by managers at various levels otherwise it cannot be successfully implemented.
5. Difficult to administer and communicate the budgeting process because more managers are involved in the process.

Summary

Hotel owners are looking for detailed justification of how each dollar is spent and how well their asset is managed. The understanding of expenses and their relationship to the revenues, room nights, food covers and other business indicators that affect profitability is critical, and the lack of documentation explaining this relationship can make the process a very tedious one.

A good budget package should eliminate the old fashion

spreadsheet budgets and give operators the flexibility to create different scenarios and associate each expense as it relates to the business. This is necessary because in the hospitality industry, expenses are constantly increasing while the revenue streams are highly variable. Database budgets will not only facilitate the preparation of zero based budgets and forecasts, but also will assist operators with providing sufficient detailed information for the hotel owners and asset managers when reviewing the annual budgets and the monthly forecasts.

It is time for hotel companies and individual hotel operators to break the paradigm of budgeting by spreadsheets and seek for the technological help to get up to speed with the tools that will help provide accurate information... Budgeting by spreadsheets is the way of the past and inaccuracy is the most likely outcome.

A budget/forecast with sufficient supporting documentation will be most likely approved faster. The variances to actual would be then easier to explain and easier to manage than a budget prepared by simple marginal increases over prior years. It is time to make department managers part of the planning process and accountable for their budgets and forecast instead of the usual process where hotel controllers are expected to do all of this alone.

General Managers must involve all departments when preparing monthly forecast and annual budgets. It is time for hotel departmental managers to be business partners instead of just being told how to run their operations and accountability should be part of everyone's performance.

The Hospitality industry is behind time, behind the other industries and behind in technology when it comes to way of budget and forecast the future so is time to shift the paradigm and move to a better database solution.



Jose Acosta is a principal at priZem inc., a provider of database solutions for budget, forecast, labor and revenue software as well as database integration alternatives that cost effectively reduce budget/forecast preparation cycles, reduce the daily labor/revenue reporting process, increase the accuracy of vital operational data, and allow for faster departmental distribution of reports. Go online at <http://www.priзем.com/> for more information on priZem's Budget Intelligence software and other products, or contact us at 212-327-2400 or sales@priзем.com for more information.

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