

## Case study 13: Mark scheme

### Chapter 31: Costs and revenues

#### Lucia's Retreat

In 2009 Lucia Valenti bought a small hotel on the seafront in Viareggio. It had excellent sea views and 30 almost identical luxury hotel suites with excellent furnishings and en suite bathrooms. She catered essentially for business visitors who were able to pay premium prices. The hotel had a small restaurant, accounted for as a separate profit centre. This was used by residents and was also open to the public. Residents were given itemised bills which listed meals eaten in the restaurant as separate items.

When she first bought the hotel, Lucia had avoided signing contracts with coach tour companies because she did not think that this type of customer was in line with the high-class image of Lucia's Retreat's target market. She had set prices of €150 per suite per night and refused to reduce prices under any circumstances. Business clients were allowed one or two months' credit. This revenue covered her direct costs of around €25 per night, thus providing a healthy contribution. For this reason she did not offer unfilled rooms on any of the last minute or late rooms websites that required price cutting.

By July 2010 the hotel was struggling to make any profit and it looked as if Lucia was going to go out of business. Overheads had been covered by mid-June but in July and August Lucia's Retreat had fewer business visitors because at that time people took holidays and therefore went on fewer business trips. Cash flow was negative as Lucia tried to keep the hotel running with few of the rooms let out. At this point, BuzzAbout Ltd, a bus tour company, contacted Lucia. After a sudden rise in demand for touring holidays they were willing to offer €50 per room per night for all the rooms still available at that point through the rest of July and all of August. Lucia did not want to accept. The price offered was far below her usual price. Her chef encouraged her to sign the contract because, with so few guests, he was starting to be worried about cash flow and whether his next salary, at the end of July, could be paid.

#### SL questions: 20 marks, 35 minutes

- 1 Define the term 'premium prices'. (2)

These are above-average prices for products or services that often sell to niche markets and have high added value or particular subjective value.

Apply **Resources table 3a** mark band descriptors.

- 2 Describe what is meant by 'direct costs' in the context of a hotel business. (3)

For a manufacturing company, these are raw material and production costs that can be clearly allocated to a single item sold, and are usually variable costs. For a hotel, these could include laundry and room cleaning costs relating to the actual occupancy of the room.

**3 marks:**

A detailed description linked to direct costs in a hotel business.

**2 marks:**

A solid definition but not linked to the hotel business.

**1 mark:**

A general description with no reference to hotels.

**3** Explain the difference between revenue and cash flow for a business like Lucia's Retreat. **(4)**

Revenue is the income received from selling a product or service. In the case of Lucia's Retreat, it would be the income from letting out rooms and from sales of hotel services and meals.

Cash flow is the difference between the inflow of money as it is actually received and the outflow of money as things are paid for. In a hotel, some people pay with cash and some people pay by credit or debit card. Money would therefore only count as a cash inflow when it is received. Similarly, outflows are only counted for cash-flow purposes at the moment when they are actually paid, e.g. when bills, wages or mortgage payments are paid.

Apply **Resources table 3b** mark band descriptors.

**4** Calculate the contribution for Lucia's normal room pricing and the contribution for the BuzzAbout reservation. **(3)**

Contribution = sales – direct costs

Normal contribution = €150 – €25 = €125

BuzzAbout reservation contribution = €50 – €25 = €25

**3 marks:**

A full and clear calculation reflecting full understanding of the concept of contribution.

**2 marks:**

A calculation with a correct answer but not reflecting clear reasoning.

**1 mark:**

An attempted calculation showing some understanding of the concept of contribution.

**5** Evaluate whether Lucia should accept the BuzzAbout reservation. **(8)**

Contribution is the amount of revenue available to pay overheads once direct costs have been paid.

**Quantitative analysis**

For	Against
The BuzzAbout deal still offers a contribution of €25. If rooms cannot be filled by traditional business customers, this is €25 that would otherwise be missed.	The opportunity cost of accepting the BuzzAbout deal is that there may be business customers who later try to reserve the rooms at full price and are unable to do so.
As the information states that overheads have already been covered, this €25 therefore represents profit.	If business customers try to book and there are no rooms available, they may find another hotel to which they might prefer to return in the future. This would translate into real lost future revenue for Lucia's Retreat in periods when there are no BuzzAbout customers to take the spare rooms.

**Qualitative analysis**

For	Against
The enthusiasm of new guests could be a positive boost to the atmosphere of Lucia's Retreat and may be enjoyed by business guests coming back from a day of meetings.	If business customers find out that BuzzAbout customers are paying a third of the price, they could become angry and take their future business to another hotel.
	Business customers may not like to be in a hotel with bus tour customers on holiday. The ambience of the hotel could change.

SL: apply **Resources table 1** mark band descriptors.

A justified conclusion is required.

For the full 8 marks, the candidate should give a balanced evaluation of both positive and negative quantitative and qualitative arguments, with at least one argument for each.

**HL questions: 25 marks, 45 minutes**

**1** Define the following terms:

**a** contribution

**(2)**

Contribution = sales revenue – direct costs

Contribution is the sales revenue left to pay overheads once direct costs have been paid.

Revenue is the income received from selling a product or service. For a manufacturing company, direct costs are raw material and production costs that can be clearly allocated to a single item sold, and are usually variable. For a hotel, these could include laundry and room cleaning costs relating to the actual occupancy of the room.

**b** overheads.

(2)

These are costs that cannot be allocated to a single service or unit produced, and do not generally change as sales volumes fluctuate. They may be associated with production, administration, selling, distribution, warehousing and finance costs. Examples include salaries and rent.

Apply **Resources table 3a** mark band descriptors.

**2** Analyse whether Lucia's chef should be concerned about whether his next salary will be paid. (6)

Define cash flow: the difference between the inflow of money as it is actually received and the outflow of money as things are paid for. In a hotel, some people pay with cash and some people pay by credit or debit card. Money would therefore only count as a cash inflow when it is received. Similarly, outflows are only counted for cash-flow purposes at the moment when they are actually paid, e.g. when bills, wages or mortgage payments are paid.

- The chef's salary is paid from cash and so any shortage in immediate cash flow could mean that the hotel is unable to pay his salary.
- Business clients may not pay their bills immediately. They may be invoiced and pay after a delay of perhaps one or two months. If this is the case, the chef's next salary, due at the end of July, would probably be paid from cash inflows from May or June guests. Therefore there is probably no need for him to worry about his July salary. It is his September salary that could rely on July room occupation.
- Cash flow may be negative in July and August but that does not mean that there would be no cash in the bank account to pay his salary. If past months had accumulated positive flows, there could be a positive balance with which to continue to pay salaries until the business customers return from holiday and start to come to the hotel again.

**HL:** apply **Resources table 2** mark band descriptors.

**3** Explain how the restaurant may be run as a separate profit centre. (6)

A profit centre is a distinct part of a business to which both revenues and costs may be allocated. To be run as a separate cost centre, revenues can be identified from residents' bills and from billing to external customers using the restaurant.

As a cost centre the restaurant must have its costs clearly identified and allocated against this revenue. It is easy to do this for food orders, wages for waiters and kitchen staff and salaries for the manager and chef. It is harder, however, to allocate fixed costs such as mortgage or rental payments (unclear which Lucia's retreat has). In order to do this, a decision must be taken to allocate overheads according to a fixed and reasoned formula, e.g. as a percentage of the total floor space.

**HL:** apply **Resources table 2** mark band descriptors.

A justified conclusion is required.

- 4 Evaluate qualitatively and quantitatively whether Lucia should accept the BuzzAbout reservation. (9)

### Quantitative analysis

Candidates first need to calculate the relative contribution of the BuzzAbout reservations in comparison with the normal business bookings:

Contribution = sales – direct costs

Normal contribution = €150 – €25 = €125

BuzzAbout reservation contribution = €50 – €25 = €25

For	Against
The BuzzAbout deal still offers a contribution of €25. If rooms cannot be filled by traditional business customers, it is €25 that would otherwise be missed. As the information states that overheads have already been covered, this €25 represents profit. It must also be noted that it is not evident exactly how many rooms are still unfilled over July and August. This represents €25 per night of overheads for every unfilled room. This could be up to a maximum of €750 (30 × €25) per night.	The opportunity cost of accepting the BuzzAbout deal is that there may be business customers who later try to reserve the rooms at full price and who are unable to do so. This would represent a potential opportunity cost of €100 for every such case.
Final profits may be increased by the extra business as long as alternative business customers do not materialise.	If business customers try to book and there are no rooms available, they may find another hotel to which they might prefer to return in the future. This would translate into real lost future revenue for Lucia's Retreat in periods when there are no BuzzAbout customers to take the spare rooms.
This would represent a continued cash flow in months when cash flow could otherwise be negative.	

### Qualitative analysis

For	Against
The enthusiasm of new guests could be a positive boost to the atmosphere of Lucia's Retreat and may be enjoyed by business guests coming back from a day of meetings.	If business customers find out that BuzzAbout customers are paying a third of the price, they could become angry and take their future business to another hotel.
	Business customers may not like to be in a hotel with bus tour customers on holiday. The ambience of the hotel could change, especially at times when tour customers vastly outnumber business customers.



HL: apply **Resources table 2** mark band descriptors.

A justified conclusion is required.