MBA Course Accounting and Finance  
Accounting

Naam: Rogier Nitschelm

Adres: Noteboom 59

Postcode en woonplaats: 4101 WS Culemborg (Nederland)

Inschrijfnummer: 817397

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**Question 1 Can any of the TallTree2 departments be run as profit centers with the department managers being able to determine price and cost for the department?**

1. **Using Worksheet #1 and the concerns expressed by the department managers, discuss the issues of each department manager when faced with the profit center approach**
2. **Comment on the difficulty in transfer pricing posed by synergies between business segments**
3. **Based upon your analysis is TallTree2 using the most appropriate responsibility centers for evaluating? If not, what changes would you suggest?**

Out-of-control

The nature of the common Casino business doesn’t lend itself well for full autonomy of each department as a profit center. Like in this case, the department of Gaming is producing a majority of the revenues (64,0%). However, Gaming does so in order to ‘relax’ the necessity for complementary departments to strife for revenues. The complementary departments are operated with the objective to keep customers located in the casino (preferably at the ‘table’) and to return when eventually they decide to leave.

When operating each individual department as profit center, several problems occur. One of such problems is the fact that departments unable to create substantial revenue, will be held responsible for results that are out of their ‘control’. Besides, in order to obtain a positive evaluation, department managers will have short-term incentives to raise prices of their complementary goods to their (internal) customers (where possible) or lower the costs. This in order to raise revenues. These higher revenues will then reflect into a (more) positive assessment of the department manager (agent) by the principal. At the cost of profitability of the business in the long term.

However, autonomy in altering prices is pretty much out of the question for both the food and beverage department, as they are restricted to complimentary duties and bargain prices.

Gaming department

The most obvious profit center is the gaming department. As they are the main force behind the profitability of the company, they need of course be operated as a profit department. It is important to watch out for free riding at the cost of the complimentary departments. As the gaming department might make excessive use of the ability to use their resources in order to raise their own revenue, by lengthening the customer’s stay in the casino.

Food department

The restaurants or food department is supposed to offer bargain prices to external customers. When offering food for these reduced prices, it’ll be extremely hard or even impossible to generate positive revenues, without cutting in the quality of chefs, personnel and the quality of supplied food. Considering personnel roughly make up for half the expenses(48,0% + 5,1% taxes), the only potential means of reducing costs is to cut in personnel.

The Restaurant department will be encouraged to hire cheap low-quality personnel to reduce costs and possibly buy budget food supplies to even further lower the costs. Sacrificing it’s advantage over rivals. The manager will have the incentive to shift quality (variable costs) from its regular restaurant services, to special events. For which retail prices can be calculated to the internal customers. But when reducing its quality for regular casino days, the more profitable clients might skip TallTree2. Having the hotel and casino attracting b-grade customers with their cheap meals instead (leaving after consuming the meal).

Considering the restaurant a profit center will generate a feeling of ‘unfairness’ due to the inability of the department’s manager to substantially influence results.

Beverage department

The beverage department is also subject to factors out of its control. As beverages are offered complimentary by a percentage of 77% (2008). Bargain prices are used to lure more customers inside the casino. The more these customers drink, the more profit the casino makes. The beverage department has a positive influence on the company’s total revenues through its synergetic pros with the gaming department, yet because of its complimentary nature, isn’t capable of generating a substantial revenue. Like the restaurant department the largest cost comes from the payroll (26,0% + 2,8%).

Deeming Beverages as a profit center will result in the means to evaluate the manager on results that are out of his control. Hence the frustration described in the case.

Hotel department

Last but not least, the hotel manager operates her segment as a profit center and is able to set her prices, yet is required to reserve 20% of the hotel rooms for high rollers. When these high rollers actually do walk in, then they will be able to obtain the room for a reduced price, of $ 45 in this case. This will give the hotel manager the incentive to reserve the 20% rooms with the lowest quality. Or cut in the expenses of the janitor, forcing customers to bring their own soap and sheets. This will in turn reduce customer happiness and even likely result in a reduction of revenues for TallTree2 as a whole. As high rollers will start visiting other casino’s with hotel facilities instead.

I do however believe that considering the nature of the Hotel department and the ability to determine the majority of the prices, that the Hotel department should be operated as a profit center. The frustrations of missed opportunity costs due to last-minute check-ins are understandable, but invalid. Yield management is one of the subjects that is well fitted for a hotel manager to be evaluated on. Besides the percentage of revenue on complimentary rooms is minimal (less than 10%), meaning a large majority (more than 90%) of the revenue can be traced back to the department manager.

A matter of importance is that the hotel department should only be evaluated on its responsibilities. The case states that the hotel manager is ‘required’ to hold 20% of the rooms. Thus the 20% reserved rooms shouldn’t be fully included in the evaluation of the manager. As this would lead to a situation of unfairness. Even though the hotel manager might not be entirely responsible for the 20%, excluding any reward or punishment for the results on the 20%, might cause the manager to shirk her responsibilities in obtaining better revenues for these rooms.

Responsibility centers

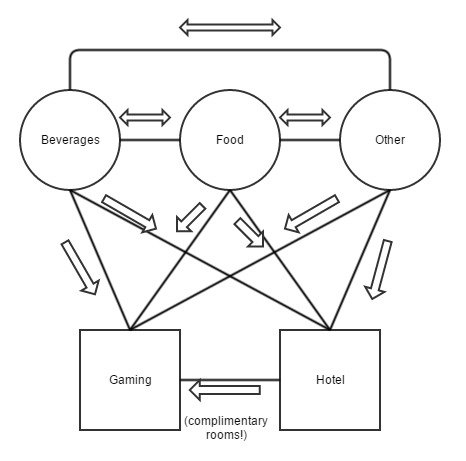
Operating the restaurant and beverage department as profit centers will result in the incentive to lower quality and or service. In other words: attempt to reduce costs – as it is the only significant means of influencing the results. I would recommend a change. One of the first options that comes to mind would be to maintain both gaming department and the hotel department as profit centers. Yet, change food and beverages into cost centers. This due to the inability to significantly influence the revenues they produce.

Summarized:

Gaming department: profit center  
Hotel department: profit center  
All other departments: cost centers

In addition to this I would recommend having financial incentives linked to TallTree2’s consolidated revenue. This to motivate each responsibility center to act in the interest of the entire company, rather than just individual success.

*Depicting the direction of service flows among departments. Note that services flow from all costs to one another, as well as to both Gaming and Hotel. Also Hotel being an ‘operating’ division, also has complementary services towards Gaming, mainly complementary rooms and suites.*



**Question 2 Worksheet #2 is the performance report for special events developed by the controller, Bill Martino**

1. **Should special events be evaluated based on profitability, or some other basis?**
2. **Evaluate the items in Bill Martino’s report and determine whether they are appropriate. Be sure to specifically address suite and room comps and hotel overhead among other line items you might question. Consider your answer to 1c) in your evaluation.**
3. **Comment on whether Judy Fitch has valid points about the costs and revenues associated with the Stars and Stripes event.**
4. **How could Worksheets #2 and #3 be combined to reflect the profitability of special events?**

Peak periods

The correct way of evaluating an event is based on the approximation of the opportunity cost of a regular casino day without a special event or a day with a different type of special event. This using the accounting cost of an average ‘slow’ day to estimate the missed opportunity of a regular day. The objective should be to limit losses or maximize profit. Whichever is likely to occur on the specific day.

The evaluation of special events should thus be based on a comparison with an average casino ‘slow’ day. Is a slow day in a casino (without event) more profitable than a day with the proposed event? Then the special event should not be held.

It is also recommended to not reduce ‘regular’ capacity during peak periods. As it is stated that even during events, most profitability comes from regular slots. The slots not transformed for the tournament.

As weekends often result in (near) full use of capacity, it’s not advised to organize special events during these days. At least no events that require slots to be transformed for a tournament. The best way of using events with a tournament element, is to hold these type of events when there is enough capacity available for regular play.

Summarized the events should be evaluated based on both profitability in comparison to regular days. The evaluation should include excess slot capacity.

Costs and revenues

I believe Fitch as a valid argument. It seems like Martino does not include the extra profit generated by the ‘regular part’ of the casino. The correct way of determining the profitability of an event is to not include fixed costs for already present overhead into the calculations. As these are sunk costs and cannot be avoided. Instead only an increase in overhead (in comparison to a regular day) + variable costs should be included as costs. The sum of this and the total revenues on the day of the event should be compared to a day without an event. Whichever one is more profitable should be chosen.

Also the hotel was running at 100% capacity. As it states that rooms could be given to regular players. Thus overhead is already calculated for cleaning costs and the like, these costs are a given (sunk costs). Now calculating an additional $ 22 for the rooms during the event would mean too much overhead is calculated, giving an inaccurate view of the costs. Regular costs and regular revenues should be extracted, as these would have occurred without the event, considering the company operating at 100% capacity. Also, the hotel receives credits for complimentary rooms and suites.

Combined sheet

The sheets must be combined in order to be able to evaluate the profitability objectively. A few modifications should be made however. To merge both the sheets, I have extracted room revenues and hotel overhead. I have added the revenues gained by regular gaming. In my opinion the accounting department doesn’t generate extra fixed costs because of the event as far as I can detect, thus I have removed the $ 100 accounting costs from the sheet. The result of the Stars and Stripes event is a net profit of $ 42.345, whereas $ 9.441 was budgeted.

Summarized for Stars and Stripes based on this specific case:

Budgeted revenues < 25.059: NO GO  
Budgeted revenues = 25.059: either GO or NO GO  
Budgeted revenues > 25.059: GO

In this the out-of-pocket costs of the special event are 25.059. As revenues passed 25.059 in both budget and actual revenues, the event can be considered a success (both in budgeted and actual terms).

It might be an idea to modify the way that budgets are made, as its pretty far off the actual result. Of course, this can only be determined when more events are held and measured by the internal accounting system.

*Sheet #2 and #3 modified and merged*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Revenues** |  | **budget** |  | **actual** |  |  |
| entry fees |  | 12.900 |  | 22.059 |  |  |
|  |  |  |  |  |  |  |
| slot handle |  | 21.000 |  | 39.010 |  |  |
| pit drop |  | 0 |  | 9.845 |  |  |
| keno write |  | 600 |  | 4.284 |  |  |
|  |  |  |  |  |  |  |
| total revenues |  |  | 34.500 |  | 75.198 |  |
|  |  |  |  |  |  |  |
| **Costs** |  | **budget** |  | **actual** |  |  |
| suite comp |  | 822 |  | 48 |  |  |
| room comp |  | 4.140 |  | 7.015 |  |  |
| buffet |  | 1.400 |  | 1.287 |  |  |
| coffee shop |  | 250 |  | 1.040 |  |  |
| casino bars |  | 100 |  | 0 |  |  |
| le moulin |  | 200 |  | 0 |  |  |
| room service |  | 500 |  | 112 |  |  |
| robo bar |  | 0 |  | 28 |  |  |
| banquet comp |  | 1.900 |  | 916 |  |  |
| Pricing & stationary |  | 2.500 |  | 1.778 |  |  |
| Postage & freight |  | 1.500 |  | 861 |  |  |
| Gifts |  | 800 |  | 1.060 |  |  |
| Trophies |  | 120 |  | 69 |  |  |
| Prize money |  | 10.707 |  | 18.309 |  |  |
| Incentives |  | 120 |  | 330 |  |  |
|  |  |  |  |  |  |  |
| total costs |  |  | 25.059 |  | 32.853 |  |
|  |  |  |  |  |  |  |
| result |  |  | 9.441 | (positive) | 42.345 | (positive) |

**Question 3 Evaluate Bill Martino’s argument for including displacement cost for hotel and casino slot revenues lost during special events. How should this be measured and when should it be used?**

Opportunity cost

Martino claims that $ 200 x 269 = $ 53.800 should be charged. However, he is in the assumption that all of a player’s average $ 200 budget is spend and the player leaves empty handed. But with only 2,1% of the gaming money spend on slots being net income, it would be unfair to calculate $ 53.800 in opportunity costs, as this is not the sum of missed revenue. Instead, when based on the average player spending $ 200 on slots with a net income for the casino being 2,1%, the calculation should be (200 x 2,1%) 269 = $ 1.129,80.

What’s worth noting is that this is only an opportunity cost when the hotel casino is using full capacity. As then it does come instead of regular costs and profits. When this opportunity is based on excess capacity however (and uses no more than the excess capacity), then one merely loses out on the means to compensate one for its sunk costs. When there is excess capacity and there is the option of gaining additional revenue (revenues must exceed out-of-pocket costs), then one should always ‘grab’ the opportunity.

**Question 4 What importance has the organization at a reliable allocation of the costs to the various activities within the organization? Indicate a specific example in the case organization that a not correct allocation of costs can lead to an undesirable situation**

The organization will benefit from transferring costs to the correct responsibility center. The more responsible the department is for the cost, the likelier the department is capable of lowering these costs. When transferring costs to a department that is unable to influence these costs, it will cause the responsible manager to experience a situation of unfairness. As well as another department, that is literally responsible for that specific cost, is able to free ride at the cost of the department that is held responsible. Possibly being able to raise revenues at the cost of the evaluation of the department that is held accountable.

One example is the cost of hotel overhead that is taken into account in the worksheet. As these costs are irrelevant considering the facts in the case (100% capacity without the event), having overhead of 5.918 calculated, will result in an actual result of 36.427, rather than 42.345. Giving a false report of potential gains from the event. As profitability is considered, this could mean potential opportunities of revenue are lost. In the example that an event’s budgeted net profit would be between 0 and 5.918, usually this would mean a GO. However, when calculating the hotel overhead of 5.918, the result would be a NO go. Meaning the hotel casino will miss out on revenue of up to 5.918, This is of course undesirable.

**Question 5 Why are opportunity costs (displacements costs) costly to estimate?**

The reason why opportunity costs are costly to estimate, is because of the many possibilities that arise when having to calculate through all options. One has to formulate all possible outcomes and calculate the net profit (or loss), that comes with those decisions. As the investment in an opportunity set is often undesirable, other methods often are preferred. One of those methods is the approximation of opportunity cost. Accounting cost, as they have been recorded in the past, can in many situations give a good approximation. As the results of past decisions will have resulted in outcomes and those in turn can be used to compare the decisions to be made (without the costly investment).

**Question 6 Do you recognize specific elements of responsibility accounting in managing The TallTree2 Hotel Casino?**

Elements of responsibility accounting can be traced in the case. For example, the hotel segment receives a charge for room, food and beverage on its performance report. As the offers of complimentary rooms are outside the full responsibility of the hotel, this is a good example of responsibility accounting.

There are also examples of bad application of responsibility accounting. Mainly the fact that certain departments are expected to operate more as profit centers, even though they are unable to considerably alter the amount of revenue obtained.

**Question 7 What role does The TallTree2 Hotel Casino’s internal accounting system play in resolving organizational problems?**

The TallTree2’s internal accounting system enables the company to measure, for example outcomes of past decisions, and therefore managerial performance and with it serves as a control function. Keen to its control function is that the variables that are measured are within the responsibility of the evaluated manager. Else it will result in issues among departments like the issues that arose as described in the case.

Another role the system fulfills is determining the possible profitability of an event, certain slots or games and departments. In other words decision making. It will help deciding whether or not an event on a specific day should be held, or if it should be moved or cancelled altogether. As profitability is the basis on which the event is judged, it is keen to maintain information about past events. Some events might be profitable, whilst others are not. It’s important to keep track of this ‘historic’ data in order to make the right decision in the future.

**Question 8 If the TallTree2 Hotel Casino would use a so called noninsulating allocation of the costs for the different departments, what advantages and disadvantages would be achieved for the TallTree2 Hotel Casino within the context of accounting for decision making and control?**

Especially when common costs are not allocated to either division, then there will be an incentive to overuse resources. If for example the food and beverage department costs are not allocated to either profit centers, the company risks abuse of these cost centers resources. Manager will attempt to reduce allocated cost with costs that are not allocated to the department. To add an example, the hotel department will be inclined to have personnel of the beverage and food department act as janitor to clean up hotel rooms, in order to lower its own costs and have the manager obtain a better evaluation by its principal.

As the degree of cooperation among the different departments is large, the substraction of resources from the cost centers beverage and food department, should be operated as a noninsulated cost. The more resources used by the gaming and hotel department, the more resources are allocated. It will motivate managers to be ‘considerate’ when obtaining resources, knowing it will influence both the own as well as the other division(s). It will also reduce the impact of random events, be it positive or negative, that disproportionately affect a division. This way it will reduce the risk perceived by the department’s managers.

Downsides of noninsulated cost allocation is the fact that managers will be partially evaluated on the performance of another department. And thus might create a feeling of unfairness and other issues. Also managers will be inclined to watch another’s performance and can create additional frustrations.

But nonetheless in the situation of The TallTree2, where there are lots of synergetic pros between profit centers and the cost centers, I believe it is wise to consider a noninsulating allocation of costs. I added a sheet with the cost allocation in 2008 based on noninsulating costs. To prevent complexity of the sheet I have considered total expenses to be allocated based on actual department’s profits.

*Based on the sheet #1 per 31 december 2008*

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **Revenues** |  | In dollars |  | In % |  |
| Gaming |  | 18.895 |  | 64,0% |  |
| Rooms |  | 4.147 |  | 14,0% |  |
| Food |  | 3.512 |  | 11,9% |  |
| Beverage |  | 1.783 |  | 6,0% |  |
| Other |  | 1.179 |  | 4,0% |  |
|  |  |  |  |  |  |
| **Expenses** |  | 14.211 |  |  |  |
|  |  |  |  |  |  |
| Considering allocation based on division profits before cost allocation | | | | | |
|  |  |  |  |  |  |
| **Noninsulated cost allocation** | | In dollars |  | In % |  |
| Gaming |  | € 9.095 |  | 64,0% |  |
| Rooms |  | € 1.990 |  | 14,0% |  |
| Food |  | € 1.691 |  | 11,9% |  |
| Beverage |  | € 853 |  | 6,0% |  |
| Other |  | € 568 |  | 4,0% |  |
|  |  |  |  |  |  |
|  |  | 14196,79 |  | 99,9% |  |

*Note (!): The difference between the total expenses and cost allocation occurs due to the percentages of the revenues being rounded. (total 100% and adding up individual percentages leads to 99,9%)*