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COST ACCOUNTING IN THE TRAVEL COMPANY

A CASE STUDY OF THE COST OF CUSTOMIZATION IN THE GROUP TRAVEL
INDUSTRY

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Abstract

The Travel Company is a company within the group travel industry offering their customers the option to completely customize their tours. This study analyzes the cost accounting of the customized tours. It examines the implications of the current cost accounting system and evaluates alternative cost accounting methods. The study is a qualitative case study and empirical information has been gathered through interviews. The cost accounting theories used are Direct Costing, Full Costing and Activity Based Costing. With their current cost accounting system the company calculates the price of a tour through summing up the tour's direct costs and adding a margin incorporating both indirect costs and profit. The size of the margin is dependant on a part of the direct costs. For customized tours a customization fee is added to the margin. However, there are large variations in time consumption, and thereby indirect costs, for different tours. We suggest that the company implements Full Costing with time as a cost driver and allocates indirect costs based on time consumption. To permit that, a time measurement system must be implemented, enabling a classification system with categories based on time consumption. Indirect costs would be allocated based on the classification system. The system would improve the company's pricing and tour portfolio decisions.

Key words: customization, cost accounting, indirect costs, time measurement

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1. Introduction

This chapter explains the background and the problem area of this study. The question, the purpose and the limitations in scope of this paper are also presented. The chapter ends with an outline of the study.

1.1. Background

The Travel Company¹ is one of the leading providers of escorted international tours in North America.² The primary focus of The Travel Company is tours to foreign destinations for North American students aged 12 to 25. The core product is the “International Tours”³ which is group tours for North American students mainly to different parts of Europe, but with some exceptions to other parts of the world. The “International Tours” is a cultural travel package, where the group travels between different destinations in order to experience the local atmosphere and attractions. The company also offers two other types of teacher-led group tours, the “Premium Tours”, and the “North America Tours”. The “Premium Tours”, is an upgraded variant of the “International Tours” and includes premium amenities and services. The “North America Tours” consist of shorter tours to major American and Canadian cities. In addition to these tours, The Travel Company also offers “Summer Academies” which is a combined educational and cultural tour. In *Exhibit 1.1* The Travel Company’s tours’ position on the global student travel market are illustrated.⁴

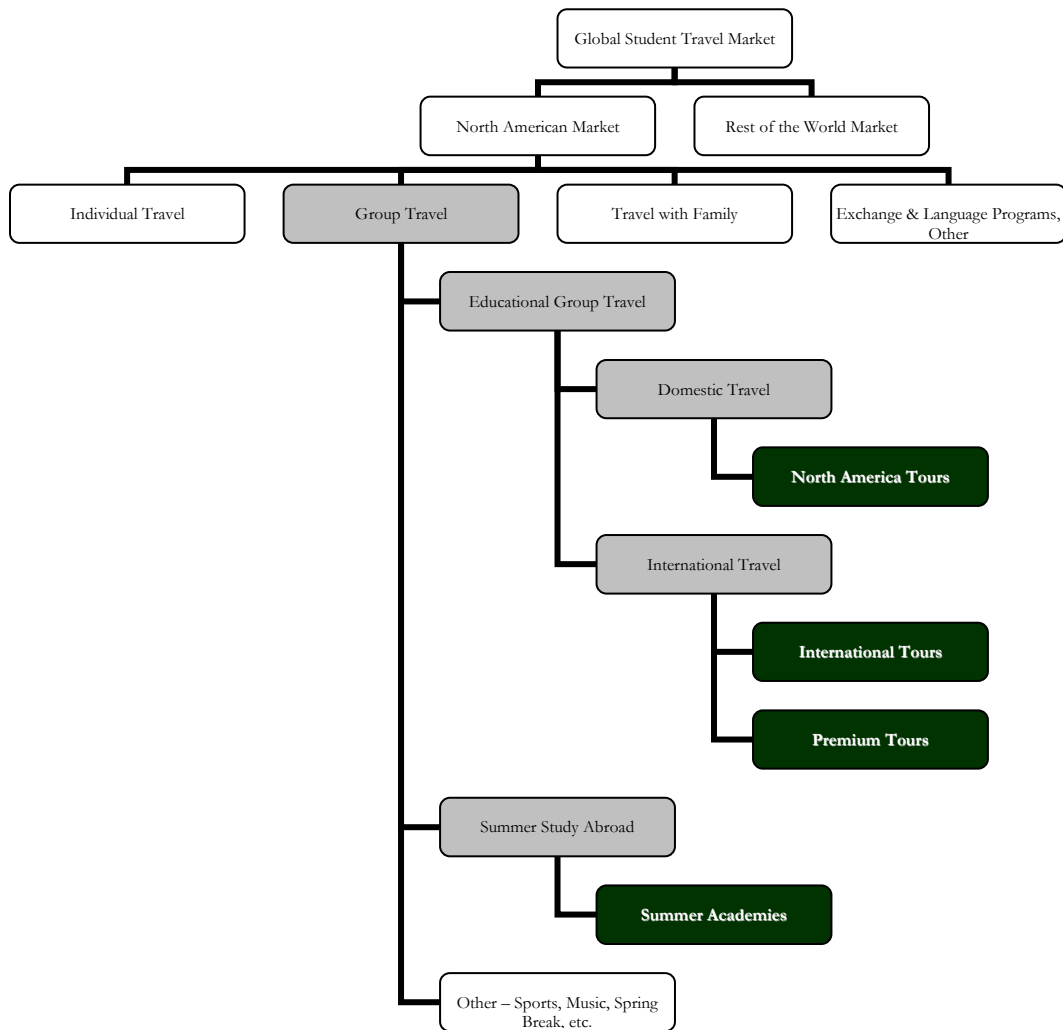
¹ In view of the prevailing competitive environment in the studied company’s industry, the company’s true name is not revealed. The Travel Company is a fictive name. For the same reason people interviewed are referred to with their title

² Based on volume with projected revenues for the fiscal year ending August 31, 2006

³ Will also be referred to as “standardized tours”

⁴ The Travel Company Information Memorandum (2006)

Exhibit 1.1 The Travel Company's products on the North American group travel market



Source: The Travel Company Information Memorandum (2006)

Note: Shading indicates markets served by The Travel Company

During the tour the groups are provided with sightseeing tours, guides, and all practical arrangements like booking flights, hotels, meals and transportation. The Travel Company also provides tour directors which accompany the teachers⁵ and the students throughout the tour. The tour directors take care of all logistics, like buying museum tickets, checking into hotels and leading the “city

⁵ If teacher-led tour

walks”. As The Travel Company employees, the tour directors also act as middlemen between the student group and The Travel Company if necessary.

The teacher-led tours are sold and marketed through the students’ teachers.⁶ By using teachers as selling channels The Travel Company is able to reach large groups in the specific customer segment. For every six students that the teacher manages to recruit the teacher has the possibility to invite one person on the tour for free.⁷ In most cases that person is the teacher’s spouse or another teacher.⁸

The Travel Company also offers the teachers the possibility to completely customize their “International Tours”. The teachers request a certain customized tour and The Travel Company creates the tour, builds an appropriate schedule and handles the bookings. Through the customization the teachers can choose the length of the tour and the countries they wish to visit. In addition, they can freely choose activities and excursion during the stay. This gives each teacher the opportunity to create a tour with a specific theme, for example a music theme where the students can explore cities with a musical history and perform. The customized tours consist of a considerable part of the total sales volume, 10–30 per cent depending on year.⁹ The Travel Company makes little effort to promote the customized tours, there are no special mailings or e-mail campaigns and the tours are given limited exposure in the company’s main brochure.¹⁰

Selling tours with the help of teachers has enabled the company to grow fast and capture large market shares in the North American market. However, since the company is relatively young the start-up cost has affected the result negatively. Additionally, external factors such as the events of September 11th, the war in Iraq and a depreciating US dollar (USD) has resulted in lower revenues than what was initially expected.¹¹

1.2. Problem Area

Service organizations experience several cost accounting difficulties. The difficulties are related to, among other things, the seemingly trivial task of knowing precisely what the firm’s “product” is. In service organizations this task might not be trivial, since service firms provide their customers with a variety of “services,” some of which represent the firm’s main product while others are ancillary.¹²

⁶ This selling method is not unique, but common in North America for these types of group travels

⁷ Chief Financial Officer (2006-09-29)

⁸ Vice President-Land Operations (2006-11-30)

⁹ Vice President-Land Operations (2006-11-14), Senior Sales Executive (2006-11-14)

¹⁰ Customized Tours Director (2006-12-01)

¹¹ Chief Financial Officer (2006-09-29)

¹² Collins & Munter (2001), p. 5

Cost accounting is predicated on associating costs with individual products. Besides the difficulty in linking specific costs to certain products it is hard to separate the costs into direct and indirect components. As a result of these separation difficulties a substantial share of costs in service organizations are classified as indirect costs.¹³ Often virtually all indirect costs are directly related to the number of people employed and their total salary.¹⁴

In service organizations output measures are not always indicative of the actual amount of service provided. Measurement problems due to the intangibility of the output of service organizations can be closely linked to perceived difficulties of standardizing services. For non standardized services management often lacks detailed knowledge of cause-effect relationships in the process of transforming inputs into output. It is often difficult for management to know what activities are triggered off in response to specific service requests.¹⁵

In accordance with the discussion above The Travel Company, as a service organization, incurs a substantial share indirect costs. The indirect costs are allocated on the basis of a part of the direct costs incurred. The direct costs consist of direct flight costs, i.e. the costs of the flight tickets, and direct land costs, such as for example hotels, tour directors, restaurant visits and excursions. The margin is not calculated as a percentage but as an absolute USD amount which should cover the indirect costs plus a profit. This USD amount margin is based on direct land costs. When pricing customized tours a customization fee is added to the standard margin. The customization fee is quite arbitrary but varies from case to case partly dependant upon how complicated the tour appears to be.¹⁶

When a teacher customizes his or her tour additional indirect costs are incurred, for example through the search for new suppliers, booking of flights, hotels and excursions and work of administrative nature. However, The Travel Company is not aware of how large the indirect costs incurred by the customizations are, why the customization fee is bound to be arbitrary. Being an entrepreneurial organization, the main priority of The Travel Company during its first years on the market has been to capture market shares. Consequently, parts of the management accounting system, for example the cost accounting of the customizations has not been focused upon to the extent needed. The neglect has resulted in unawareness by the management of the total costs for the service provided. The Travel Company has not studied what activities are triggered off by a customization and the

¹³ Modell, Sven (1996), p. 59

¹⁴ McDonald & Stromberger (1969), p. 114

¹⁵ Modell, Sven (1996), p. 60

¹⁶ Custom Pricing Administrator (2006-11-15), Customized Tours Director (2006-11-14)

management states that they lack knowledge of the exact costs of the company's customized tours.¹⁷ The company has never investigated how much time is actually spent, i.e. how much additional indirect costs are actually incurred, handling the customizations.¹⁸ Without further knowledge of the costs the management will not be able to incorporate them in the final tour price nor make well founded tour portfolio decisions.

If the indirect costs incurred by customers customizing their tour were identified The Travel Company would gain a better understanding of its cost structure and thereby learn the true cost of customization and their tours. We believe that it is important for The Travel Company to understand which customizations are profitable. The indirect costs need to be properly identified and allocated so that the tours could be properly priced.

1.3. Purpose and Question

The purpose of this study is twofold. Firstly, it is to analyze The Travel Company's current cost accounting system and secondly to examine whether there might be a cost accounting system that would better suit The Travel Company. Concretely, this study is concerned with finding the answers to the following questions;

- 1) *What are the implications of The Travel Company's current cost accounting system for customized tours?*
- 2) *Is there any cost accounting system that The Travel Company could use that would better reflect their indirect costs and how should these costs be connected to the customized tours?*

1.4. Delimitations

The Travel Company is an entrepreneurial organization with a number of different products, which has experienced strong growth in the number of travelers in the last few years and which additionally is operating on a market that might often be difficult to predict. Due to these factors there are a number of issues in the company's management accounting system that could be improved. However, to be able to keep this study as specific as possible we have been forced to make a number of limitations and prioritizations.

We decided together with The Travel Company to focus solely on the "International Tours". For the reasons stated above it was only possible to study one type of tour and "International Tours" was chosen since it makes up the majority of The Travel Company's sales.¹⁹ Furthermore, we limit our

¹⁷ Chief Financial Officer (2006-09-29), Vice President-Land Operations (2006-09-30)

¹⁸ Chief Financial Officer (2006-09-29)

¹⁹ Chief Financial Officer (2006-09-29)

study to the indirect costs incurred by the fully customized “International Tours”. We are analyzing the indirect costs incurred by the customizations in Sales, Customized Tours, Land Operations and Flight. The customizations might very well incur additional indirect costs in other functions²⁰. However, only the stated functions have been our focus since both our and The Travel Company’s impression is that it is in those the customized tours incur most of the indirect costs, seeing that it is those functions that mainly handle the customized tours.

1.5. Disposition

Chapter two explains the chosen research approach and method, describes the type of information that has been collected and illustrates how the study was conducted. In chapter three we describe the theories we intend to use when analyzing the findings. In chapter four the different functions are presented, The Travel Company’s process of handling the customizations in the functions is discussed and the company’s present cost accounting system is described. In chapter five the empirical findings are analyzed. The implications of The Travel Company’s current cost accounting system are discussed and alternative cost accounting methods are presented. In chapter six our findings are summarized and we answer the research questions which were stated in the beginning of the study. In chapter seven, the last chapter, we discuss the validity and reliability of this study.

²⁰ To facilitate for the reader we in this study refer to the different parts of the company with different responsibilities as *functions*

2. Method

The purpose of this chapter is to explain the research approach and method chosen and to describe how the information in this study has been collected.

2.1. *Research Approach*

In general, there are two approaches that can be used to perform an empirical study, the *deductive* and the *inductive* approach. Before the study commences the researcher must decide which one to use. When using the inductive approach a theory result from a process that evolves gradually as empirical information is collected. Firstly, empirical information is gathered and thereafter a theory is deduced from that information.²¹

The deductive approach is more formalized and the opposite of the inductive approach. When using the deductive approach new hypotheses are deduced from theories through the testing of empirical findings. The researcher firstly defines or chooses a theory and thereafter tests, with the help of the empirical findings, whether the theory is applicable in reality or not.²²

The research approach that we deemed appropriate in our study is a combination of the inductive and deductive approaches; the *abductive* approach. In similarity with the inductive approach, the abductive approach takes its starting point in empirical facts but also takes theoretical concepts into consideration.²³ Our motive for using the abductive approach in our study is that it enables a combination of empirical analysis of The Travel Company with studies of existing theories. We believe this mixture of empirics and theory to be rewarding since it facilitates the understanding of the challenges and issues raised by customization in The Travel Company. By alternating between theory and empirics throughout the study, continuous understanding of the two in the light of each other is enabled.

2.2. *Research Method*

Research methods could involve case studies, action research, surveys, experiments, analysis of archival information etc. When choosing research method three conditions should be taken into consideration: i) the type of research question posed, ii) the extent of control an investigator has over

²¹ Holme & Solvang (1997), p. 51 f

²² Ibid

²³ Alvesson & Sköldbberg (1994), p. 42

actual behavioural events, and iii) the degree of focus on contemporary as opposed to historical events.²⁴

For this study the case study is considered appropriate since it focuses on a *how* The Travel Company could ameliorate its cost accounting system, there is limited control over actual behavioural events and it concerns a contemporary phenomenon. However, the case study in this paper also contains elements of action research. Action research involves collaboration between practitioners and researchers. According to Eden and Huxham, the findings of action research result from “involvement with members of an organisation over a matter which is of genuine concern to them”.²⁵ Action research also differs from other forms of applied research since it explicitly focuses on action, in particular the promotion of change within the organisation.²⁶

2.2.1. Methods for Data Collection

Data can be collected by either using a *quantitative* or a *qualitative* method. The quantitative method is more formalized and structured and can be easier controlled by the researchers. It is characterized by a distance from the information source. Statistical methods play a significant role in the analysis of quantitative information.²⁷

The qualitative method is less formalized. It is concerned with obtaining a high degree of understanding for the problem being studied and also attempts to comprehend its context. The method is characterized by a short distance from the information source and the researchers try to understand the situation from the perspective of the person/unit studied.²⁸

In case study research qualitative as well as quantitative methods are possible. The limited availability of information²⁹ as well as the need to attain a high degree of understanding of the problem studied, made us deem the qualitative method appropriate for our study.

2.3. Data Collection

When collecting data, researchers make a distinction between *primary* and *secondary* data. Primary data refers to new data, i.e. data that is collected by the researchers, while secondary data refers to data

²⁴ Yin (2003), p. 5 f

²⁵ Eden & Huxham (1996), referred to in Saunders et al. (2000), p. 95

²⁶ Saunders et al. (2000), p. 95

²⁷ Holme & Solvang (1997), p. 14

²⁸ Ibid

²⁹ The limited amount of time at our hands and the fact that The Travel Company had never investigated the time consumption for neither the standardized nor the customized tours made quantitative information concerning time consumed when handling the tours extremely limited and arbitrary

which has already been collected.³⁰ In this study we have used a mix of primary and secondary data but the main focus has been on primary data in the form of interviews. Conducting interviews is a common method and important tool for the gathering of information for qualitative case studies.³¹

In the initial stage of the study, secondary data, in the form of The Travel Company's extensive Information Memorandum and relevant cost accounting literature, was studied. In the later stage, the majority of our interviews were conducted. This approach enabled us to initially build a knowledge base that allowed us to ask relevant questions in the interviews where we gathered information that could not be found elsewhere.

Two categories of interviews, *informant* interviews and *respondent* interviews can be distinguished. Informant interviews are interviews where the interviewee is not involved in the phenomenon under study, but possesses important knowledge of it. Respondent interviews, on the other hand, are interviews where the interviewee is actively involved in the phenomenon under study.³²

In the initial stage of our study we conducted several informant interviews in order to define the problem and create an initial understanding of the problem area. In the later stage, we conducted respondent interviews with employees at various organisational levels in The Travel Company, all actively involved in the customization process.

Interviews can vary in their degree of structure, ranging from completely structured, where the exact questions and the order of the questions are decided upon beforehand, to completely unstructured, conversation-like interviews, where the questions are not determined beforehand. In the initial stage of our study we conducted unstructured interviews. Unstructured interviews are useful when the researcher does not possess enough knowledge and information of the subject to ask relevant questions, thus the interview is essentially explorative. One of the goals of the unstructured interview is to learn enough about a situation to be able to formulate questions for forthcoming interviews. In the later stage, we conducted semi-structured interviews. Semi-structured interviews are directed by few questions to be investigated, but neither the exact wording nor the order of questions is decided upon beforehand.³³

³⁰ Holme & Solvang (1997), p. 132

³¹ Merriam (1994), p. 86

³² Holme & Solvang (1997), p. 104

³³ Merriam (1994), p. 87 f

2.3.1. Conducting the Interviews

In order or to fulfil the purpose of this study we ensured that we would interview employees from all the different functions of interest for this study. With this objective in mind, we conducted interviews with 10 employees from different functions and with varying responsibilities. We spent two days at one of The Travel Company's offices conducting interviews as well as gaining informal insights. In *Table 2.1* we have compiled the interviews.

Table: 2.1 Conducted interviews

Interviewee	Category	Level of Structure	Form	Date
Chief Financial Officer	Informant interview	Unstructured	Meeting	2006-09-29
		Unstructured	Meeting	2006-10-12
Vice President-Land Operation	Informant interview	Unstructured	Meeting	2006-09-30
		Semi-structured	Meeting	2006-11-14
Senior Sales Executive	Respondant interview	Semi-structured	Meeting	2006-11-14
		Semi-structured	Meeting	2006-11-15
Customized Tours Components Coordinator	Respondant interview	Semi-structured	Phone	2006-11-14
Customized Tours Director	Respondant interview	Semi-structured	Phone	2006-11-14
Yield Manager	Respondant interview	Semi-structured	Phone	2006-11-14
Custom Pricing Administrator	Respondant interview	Semi-structured	Phone	2006-11-15
Program Manager Assistant	Respondant interview	Semi-structured	Phone	2006-11-15
Regional Sales Manager	Respondant interview	Semi-structured	Phone	2006-11-17
Vice President-Flight	Respondant interview	Semi-structured	Phone	2006-11-17

In addition to the interviews we used e-mail correspondence to clear out uncertainties.

The most commonly used method to register interview information is through tape recording. By recording the interview the researcher can be sure that everything that has been said during the interview is available and ready to be analyzed. A second method to register interview data is to take notes throughout the interview. Since it is not possible to write down everything that is said and since

the researcher during the study's initial phase cannot be sure of what may turn out to be important information, this method is only recommended when tape recording is not possible.³⁴

At the interviews where we had meetings with the interviewees, we registered the interview using a tape recorder and we also took supplementary notes. When the interview was conducted over the phone, tape recording was not possible and hence we only registered the interview material by taking notes.

³⁴ Merriam (1994), p. 96

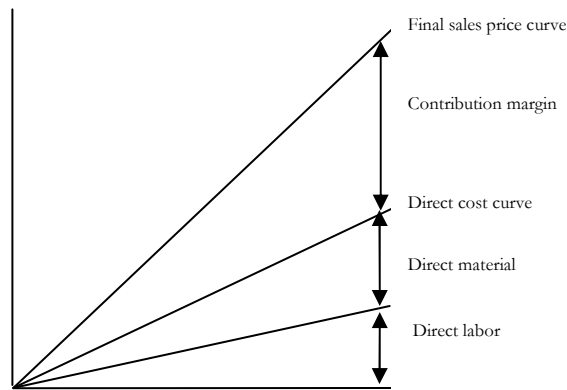
3. Theoretical Framework

This chapter describes the cost accounting theories we intend to use in the study for the purpose of analyzing our empirical findings. The cost accounting theories chosen are Direct Costing, Activity Based Costing and Full Costing. These particular theories were chosen since through them both The Travel Company's current cost accounting as well as alternative methods are covered.

3.1. Direct Costing

In the Direct Costing method only the costs that are directly traceable to the production of a specific product, are allocated. These costs are called direct costs and often consist of direct labor and direct material. Direct costs vary directly with changes in production or sales. Indirect costs, which are not directly related to a specific product but still incurred by the business, are included in the costing through the contribution margin.³⁵ Including both indirect costs of the period and expected profit, the margin represent the contribution from a specific item of a product.³⁶ Hence, the direct costs together with the contribution margin make up the final sales price. (See Exhibit 3.1)

Exhibit 3.1: Reaching the final sales price through direct costing



Source: Wilson (1983), p. 276

³⁵ Wright(1962), p. 2

³⁶ Wilson (1983), p. 276

The Direct Costing method is especially suitable if the sales price of a product is given by market forces. In Direct Costing it is easy to detect the contribution that every single unit brings and thus its contribution to the covering of fixed costs. Therefore, it is possible to distinguish which product portfolio that is beneficial for the business in the short-run.³⁷ However, the company should be aware that this is only applicable in short-run decision making, since the indirect costs must be incorporated into the company's long-term profitability planning. If they are not, the company using Direct Costing for pricing decisions may risk accepting margins that are inadequate for the managing of future profitability.³⁸ Direct Costing is therefore not regarded appropriate as a pricing method in the long-run.

Another problem to consider is that Direct Costing does not provide adequate information when used to analyze cases that fall outside of the current capacity situation. If a company experiences increasing demand, which cannot be handled based on existing capacity; Direct Costing does not incorporate the additional costs incurred, such as additional overtime or new machinery.³⁹

Yet another difficulty is that costs can vary between direct and indirect interchangeably and it can often be difficult to decide upon a classification without a thorough analysis. The analysis must continuously trace all costs associated with the product, such as facilities, machines and personnel, in order to enable an accurate classification.⁴⁰

3.2. Full Costing

3.2.1. What is Full Costing?

The Full Costing method is based upon the traditional approach that all common costs should be allocated to products, no costs should remain unallocated. By using this method as a basis for pricing the company is able to transfer all cost to customers.⁴¹

3.2.2. Assigning Costs to Products and Services

The costs are allocated by firstly summarizing all direct costs related to the product or service. The direct costs are naturally dependant upon the product or service but often consist of labor and material costs. The product's share of the indirect costs is subsequently added to the direct costs. Since tracing indirect costs back to specific products is often both difficult and time consuming, the

³⁷ Bergstrand (2003), p. 45

³⁸ Bragg (2001), p. 140 f

³⁹ Ibid, p. 141

⁴⁰ Ibid

⁴¹ Bergstrand (2003), p. 42

allocation of these is usually done through a percentage share. A percentage of indirect costs is added to the direct costs already calculated. This percentage is directly related to the direct costs used by that specific product, i.e. the direct costs are used as a basis when calculating the amount of indirect costs to be allocated.⁴² Hence, the indirect costs are assumed to be directly proportional to the direct costs, which have the function of a *distribution key*.⁴³ For instance, indirect costs that are traceable back to material are allocated through a percentage share of direct material costs. The allocation method is based upon the assumption that direct costs and indirect costs are correlated, which in turn would imply that products with high direct material costs incur high indirect material costs.⁴⁴ Indirect material costs could be costs in the buying process, inventory handling and interest costs. The same kind of allocation reasoning holds for the indirect production costs, such as cost of capital for facilities and machinery, but they are usually allocated through a percentage of a different distribution key, direct labor costs.

It is also possible to use alternative ways of distributing the indirect costs. For example by distinguishing what really is included in the indirect costs and what is actually driving them, i.e. *cost drivers*. If the largest part of indirect material costs can be traced back to the holding of inventory the distribution of indirect material costs could be based upon for example used floor area or volume. Furthermore, materials that need more expensive inventory space should be charged more than materials that do not have such special needs. Through this distinction it is possible to obtain a more correct cost allocation than what is possible through the usage of a standard allocation base with direct costs as a distribution key.⁴⁵

A product normally passes through several different steps in the production process. At each step a different cost driver could be used. More cost drivers specified in the analysis facilitates the obtaining of a correct picture of the product's true costs, since the calculations otherwise often tend to be simplified and standardized. However, there must always be a balance between accuracy and cost of measurement.⁴⁶

The direct costs and the allocated indirect costs attributable to the production totals the production cost. By using the total production cost as basis, indirect costs not directly attributable to the production process, for example administration- and sales costs, could be allocated through a

⁴² Bergstrand (2003), p. 46

⁴³ Andersson (1997), p. 91 f

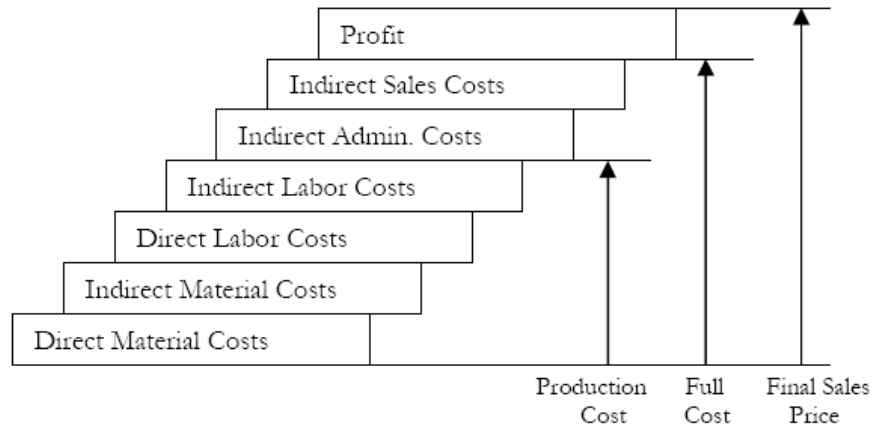
⁴⁴ Ibid, p. 95

⁴⁵ Ibid, p. 97

⁴⁶ Ibid, p. 99

percentage share. The full cost includes both the production cost and all non-production related indirect costs. The final sales price includes full cost plus a profit. The profit could either be added as a percentage of the full cost or be calculated as a margin of the final sales price.⁴⁷ (See Exhibit 3.2)

Exhibit 3.2: Production cost, full cost and final sales price according to the Full Costing method



Source: Andersson (1997), p. 93

3.2.3. Applying Full Costing to Service Industries

Full Costing of products and services are based upon the same basic principles. However, since service companies are often more labor intensive the dominating share of costs are usually attributable to labor costs. A large part of these are often direct costs for produced services and should be directly allocated to the specific service provided. Direct labor costs could then be used as the starting point when allocating the indirect costs.⁴⁸

3.2.4. Problems with Full Costing

The allocation of all indirect cost through a percentage share has given rise to criticism. Firstly, the costs are not allocated on the basis of used resources but on the basis of total costs in the company. This could result in a product being charged with higher costs than it has actually incurred since all costs must be allocated, even if the product using the resource does not use or need the total capacity.⁴⁹ Secondly, a miscalculation of, for example, the labor costs could multiply with the

⁴⁷ Andersson (1997), p. 96

⁴⁸ Ibid, p. 112 f

⁴⁹ Bergstrand (2003), p. 52

percentage share, consequently resulting in unrealistic and misleading product calculations.⁵⁰ Thirdly, a potential problem is the allocation of research and development costs since they are not related to products sold today. Nevertheless, the costs must be handled in some way. This could be done either through allocation to current products, thereby overestimating the product's costs, or by capitalizing the costs in the balance sheet.⁵¹

3.3. Activity Based Costing

3.3.1. Why is Activity Based Costing important now if it was not important in the past?

Activity Based Costing (ABC) gained in importance as a cost system mainly for two reasons. Firstly, the changing cost structure of many contemporary organizations and secondly the increasing diversity of products and services that companies are producing and selling. In traditional labor-intensive manufacturing companies the vast majority of product costs usually consist of direct costs that can easily be traced back to the product. In that case the inaccuracies created by improper assignment of indirect costs to products have only a small impact on individual product cost. In contrast, in many of today's companies a significant share of costs are indirect and in this case an improper assignment of indirect costs can have a large impact on individual product cost and lead to the wrong pricing and product profitability decisions. In addition, in companies that produce and sell either one product or products that are somewhat similar in nature the indirect costs consumed by various products are quite equal. However, in a case where the company sells several and often significantly diverse products or services the consumption of the indirect costs can differ considerably from one product to another.⁵²

3.3.2. What is Activity Based Costing?

ABC developed to provide more accurate ways of assigning the indirect costs to activities, business processes, products, services and customers.⁵³ When doing an ABC-calculation the first step is to, as far as it is possible, identify direct costs and direct material, the same procedure as in the Full Costing calculation. Thereafter indirect costs are focused upon and resource demanding processes are grouped into a number of *activities*.⁵⁴ In the next stage, the ABC system traces activity costs to different products through the identification of a *cost driver* for each activity. A *cost driver rate* is then

⁵⁰ Bergstrand (2003), p. 47

⁵¹ Ibid, p. 49

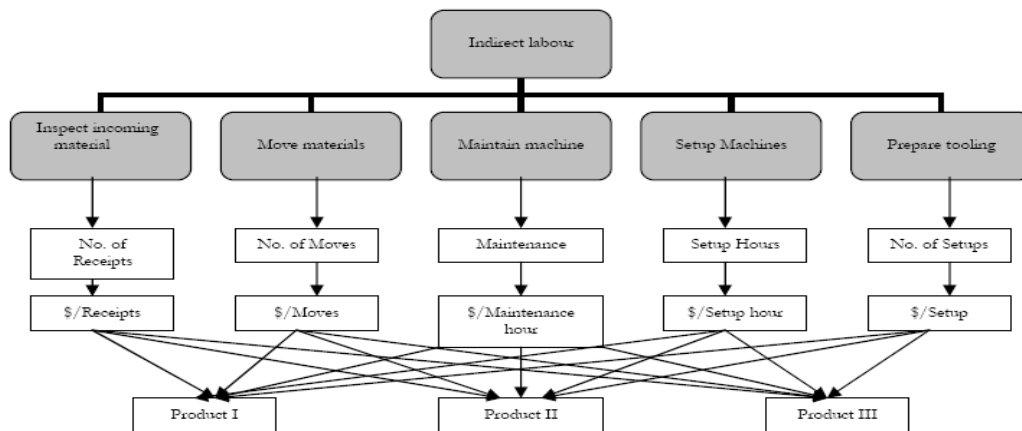
⁵² Latshaw & Cortese-Danile (2002), p. 30 f

⁵³ Kaplan & Atkinson (1998), p. 97

⁵⁴ Bergstrand (2003), p. 57

calculated and this rate is used to drive activity costs to products. For each product (or service or customer) the quantity of each cost driver used during a period is multiplied by the cost driver rate. *Exhibit 3.3* shows how indirect labor could be decomposed into five different activities performed and then linked, via appropriate cost drivers, and cost driver rates to different products.

Exhibit 3.3: Expenses flow from resources to activities through cost drivers to products



Source: Kaplan & Atkinson (1998), p. 98

The goal of ABC is not to succeed in allocating all common costs to products but to measure and then price out all the resources that are actually used for activities that support the production and delivery of products and services to customers. The resources that in fact do not support the production and delivery of products and services should not be allocated. This will become particularly evident in the case of overcapacity. The overcapacity will in the ABC system not be allocated to products but will instead be accounted for as unallocated costs attributable to the cost center where they were incurred and will work as an indication that there is a need for improvement.⁵⁵

By calculating costs using practical instead of total capacity the company will obtain a lower cost per product than by using the Full Costing method. This could, in turn, facilitate the understanding of and reaction to the prices on the market. Consequently, the company will have an evident indication of whether a product or service is profitable or not, and if the long-term prices will not reach the ABC cost the production of that product should be terminated. However, the ABC-calculation will not provide the company an immediate basis for pricing or product portfolio decisions. On the

⁵⁵ Bergstrand (2003), p. 61

contrary, it is of great importance to interpret the ABC-calculation being aware that there are large unallocated costs in the company and to cover those, prices must naturally be set higher than the indicated ABC costs.⁵⁶

3.3.3. Assigning Costs to Activities and Selecting Cost Drivers⁵⁷

The data needed to link resource spending to the activities performed can be collected from employee surveys. Individuals, other than those doing the actual production work, are asked to fill in a survey in which the activities are listed. The employee is asked to estimate the percentage of time spent on any activity (in excess of e.g. 5 per cent of their time) on the list.

The selection of a cost driver always reflects a subjective trade off between accuracy and the cost of measurement. Because of the vast number of potential linkages between activities and products, designers try to economize on the number of different cost drivers used. The type of cost drivers normally used by ABC system designers are divided into *transaction*, *duration* or *intensity*.

Transaction drivers, for example the number of setups or number of receipts, count how many times an activity is being performed. Transaction drivers can be used when all products make basically equal demands on the activity. Transaction drivers are the least costly type of cost driver but could also be the least precise since it is assumed that the same quantity of resources is required every time an activity is performed.

Duration drivers represent the amount of time required to perform an activity. Duration drivers should be used when there is significant variation in the amount of activity required for different outputs. Examples of duration services include setup hours and direct labor hours. Duration drivers are more precise than transaction drivers, but they are much more expensive to implement since they require an estimate of the duration each time an activity is performed.

However, for some activities, even duration drivers may not be precise enough. *Intensity drivers* reflect the cost of extra personnel, particularly skilled personnel and expensive equipment that may be required on some setups but not on others. Intensity drivers are the most precise cost drivers but are also the most expensive to implement.

⁵⁶ Bergstrand (2003), p. 63 f

⁵⁷ Kaplan & Atkinson (1998), p. 98 f

3.3.4. Applying Activity Based Costing to Service Industries⁵⁸

The basic principles of building ABC systems are the same for service and manufacturing companies; however there are some differences which can be observed in practice. Many service organizations transact directly with their customers. Therefore, more use of duration drivers can be expected since the transaction with customers may differ in complexity. The time needed to resolve a customer request might vary depending upon the complexity of the situation being handled.

3.3.5. Problems with Activity Based Costing⁵⁹

Even though an ABC system can resolve many difficulties it has several attendant problems that could result in system installation failures. ABC is most useful in organizations that have multiple product lines, automation and involve complex production processes. Installed in an organization which meets these criteria the ABC system could be very efficient, but if it does not, the organization might not be in need of the system. Since ABC has earned a good reputation there is a risk that managers tend to believe implementing ABC will create wonders in the organization without considering the organizations need and fit for it. Organizations with a single product line and simple processes might attain reasonably correct costing information with another system, without implementing a complex and time consuming ABC system.

Since ABC implementation and follow-ups are often time consuming and require extensive information of activities to make it worthwhile, inertia among department managers might be a problem. High-level managers must take a personal responsibility for the implementation to be done properly.

3.3.6. Designing the Optimal System⁶⁰

ABC systems use many estimates. These estimates are made, not because it is impossible to trace actual costs to particular events, but because the cost of doing a detailed and actual cost tracing often greatly exceeds the value or benefits. The goal should be to have a cost system that balances the cost of errors made from inaccurate estimates with the cost of measurement. Traditional cost systems might be inexpensive to operate, but often lead to large distortions from the actual cost of activities, processes, products, services or customers. As a result, managers might make serious mistakes in decisions made on the basis of this information; the cost of error is high. But trying to build an ABC system with numerous activities and using intensity drivers to trace the costs for each product or

⁵⁸ Kaplan & Cooper (1998), p. 458

⁵⁹ Bragg (2001), p. 215 f

⁶⁰ Kaplan & Atkinson (1998), p. 110 f

service would lead to an enormously expensive system. The cost of operating such a system would greatly exceed the benefits in terms of improved decisions made and only offer slightly more accurate information than would a relatively simple system.

4. Empirical Findings

This chapter describes the functions of interest for this study and the process of handling the customized tours in each of them. The chapter also presents different customization scenarios. Lastly, the current cost accounting system in The Travel Company is described.

4.1. Functions

Below we describe the handling of the customizations in the four functions mainly involved in the customization process: Sales, Customized Tours (CTT), Land Operations and Flight. The functions' activities described below are solely attributable to the handling of the customizations even though in three of the functions (all but in CTT) the handling of the customizations is only one part of the employees' work tasks.

4.1.1. Sales

Sales is the function in direct contact with the teachers. When a teacher has a request concerning a customized tour he or she contacts one of Sales' Program Consultants (PC). The PC:s help the teachers put together a tour in the cases when they do not already have a clear picture of what they want to do and what is logistically possible. After having come to an agreement with the teacher regarding the outline of the tour, the PC passes the pricing request on to CTT. The PC has continuous contact with the teacher until the time of departure. The early stages of correspondence concerns pricing and tour outline. In the later stages, the PC answers questions and sees to that all travelers receive the information needed, they also send out the flight tickets. The communication with the teachers is mostly done with the help of e-mails alternatively over the telephone.⁶¹

4.1.2. Customized Tours

CTT was created in 2005. The customized tours were quickly becoming more popular⁶² and The Travel Company also realized that the customized tours were more time consuming than they had initially thought. Consequently, a function assigned to handling those tours was established, CTT is the only function within The Travel Company that solely handles customized tours. They are responsible for the pricing of all customized tours. The function firstly tries to estimate the direct costs for the customized tours and secondly sums up the total direct flight and direct land costs and adds a margin.⁶³ When a tour has been booked CTT also enters the information about the tour into

⁶¹ Regional Sales Manager (2006-11-17)

⁶² Vice President-Land Operations (2006-11-15)

⁶³ Custom Pricing Administrator (2006-11-15)

the Program System. The Program System contains information about activities, schedule, components⁶⁴ and prices.⁶⁵ Lastly, before this information becomes available for the teacher and employees in the other functions to see, CTT checks if the right activities and components have been included.⁶⁶ The functions can access the Program System through The Travel Company's intranet and they can search for a specific tour and see the tour details by entering the tour's reference number.⁶⁷

4.1.3. Land Operations

Land Operations search for suppliers, who could offer activities, hotel rooms, meals, excursions, or anything else the teacher might wish for, with a good quality at a reasonable cost. For recent tours the searching for costs have involved a spectrum of varying difficulty, such as finding the cost for an overnight train from Munich to Florence to something more complicated, such as finding the costs and suppliers for renting 40 violins in Salzburg and transporting them in a bus through Europe. When a tour has been entered into the Program System Land Operations also handles all the bookings with suppliers. When there is a request which concerns a supplier with whom Land Operations has already established a contact, the process of finding costs and making bookings is naturally facilitated. If Land Operations does not have an established contact, the process of finding and establishing the contact could be complicated and time consuming. To find suppliers Land Operations search the internet. The communication with suppliers and other functions are mostly done through e-mail correspondence and sometimes over telephone. Land Operations are divided into five geographical areas with each employee being responsible for one specific area. The areas are: UK, Scotland & Ireland, France, Belgium & China, Spain, Portugal & Costa Rica, Italy & Greece and North America.⁶⁸

4.1.4. Flight

Flight is responsible for estimating flight costs and booking requested flights for The Travel Company's travelers. Flight normally requests the costs for the flight tickets eleven months in advance. However, the function then only receives the net fair for a flight ticket from the airline and must estimate the fuel surcharge and airport taxes. The reason is that fuel surcharges and airport

⁶⁴ Components are the specific costs for each part of a tour, e.g. the entrance fee to the Louvre is one component, the cost of a triple hotel room in Rome is another

⁶⁵ Program Manager Assistant (2006-11-15)

⁶⁶ Customized Tours Components Coordinator (2006-11-14)

⁶⁷ Senior Sales Executive (2006-11-14)

⁶⁸ Senior Sales Executive (2006-11-14)

taxes may vary with time and therefore the airline can only provide the net fair so far in advance. Hence, Flight must take into account for example future oil prices when making their cost estimates. For a customized tour the cost estimates are often more difficult and time consuming since customized tours often involve more alternate airports, i.e. an airport not used in The Travel Company's standardized tours. When the function does not have an established contact with the airport the request requires additional time to handle.⁶⁹

4.2. Process

A request of a customized tour launches a chain of reactions within The Travel Company. We will present five different possible scenarios, which we have identified, in order to illustrate how the work flow might fall out when the functions handle a customized tour request. The process of handling a customized tour request differs between different tours. How the process will actually materialize in reality is dependant upon the complexity of the specific request.

In *Scenario 1* we present the entire process, from the teacher requesting a price suggestion for a customized tour to the final pricing and Program System approval. In the subsequent scenarios we only present the parts where the scenarios differ. The scenarios grow in complexity, i.e. *Scenario 1* is the least complex and *Scenario 5* the most complex.

4.2.1. Scenario 1

The work flow starts off by the teacher submitting a request by e-mail or over the phone (A in *Exhibit 4.1*). The PC receives the request and evaluates whether the requested tour is logistically possible. If not, the PC re-contacts the teacher and the two communicate back and forth until a realistic tour has been outlined. When a realistic outline has been established the PC passes the pricing request on to the Custom Pricing Administrator (CPA) in CTT (B in *Exhibit 4.1*).⁷⁰

In the next stage of the process, the CPA decides whether she is able to estimate the costs of the requested customized tour, which is possible if it is similar to a standardized tour. For all standardized tours costs already exist as components in the Program System. Components not needed are deducted and new components are added. The CPA sums up the direct cost; i.e. land and flight costs given by the components in the Program System. To the direct costs the margin, i.e. indirect costs plus profit, is added. The price of the tour is subsequently sent back to the PC.⁷¹

⁶⁹ Vice President-Flight (2006-11-17)

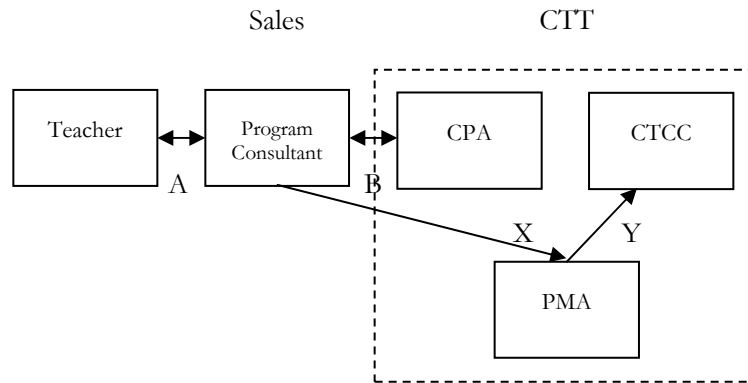
⁷⁰ Regional Sales Manager (2006-11-17)

⁷¹ Custom Pricing Administrator (2006-11-15)

The PC forwards the price to the teacher. If the teacher does not accept the suggested price the PC tries to re-price the tour through minor changes in the tour outline. If the PC is not able to re-price the tour, the outline must be modified and, consequently, a new pricing request is sent to the CPA. The outlining and pricing require the PC and teacher to, on average, communicate back and forth ten times. The CPA, on average, needs to re-price a tour twice.⁷²

As soon as the teacher accepts the suggested price the PC sends the tour details to the Program Management Assistant (PMA), a CTT employee, who enters the information into the Program System (X in *Exhibit 4.1*).⁷³ However, before the information becomes available for the teacher and Land Operations to see, it requires approval by the Customized Tours Components Coordinator (CTCC) who ensures that the correct information has been included in the Program System (Y in *Exhibit 4.1*). After approval, Land Operations and Flight can proceed with the bookings.⁷⁴

Exhibit 4.1: Scenario 1



Source: Customized Tours Components Coordinator (2006-11-14), Custom Pricing Administrator (2006-11-15), Program Manager Assistant (2006-11-15), Regional Sales Manager (2006-11-17)

⁷² Regional Sales Manager (2006-11-17)

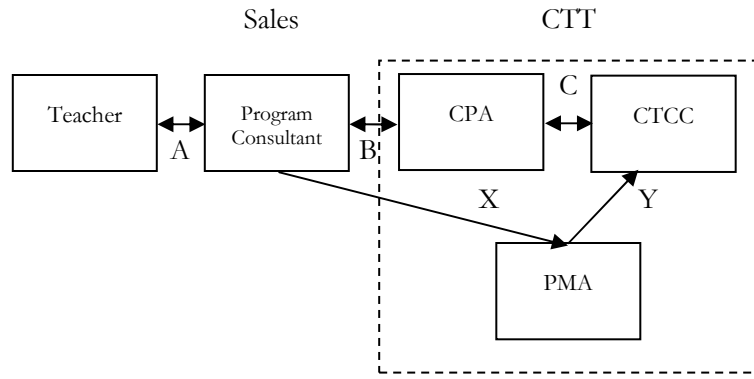
⁷³ Program Manager Assistant (2006-11-14)

⁷⁴ Customized Tours Components Coordinator (2006-11-14)

4.2.2. Scenario 2

If the CPA does not succeed in finding the cost of a customized tour in the Program System, the costing request is forwarded to the CTCC (C in *Exhibit 4.2*). In some cases components exist in the Program System but are difficult to find. The CTCC is responsible for coordinating the components in the Program System, which enables him to find components which are rarely used and therefore difficult for the CPA to find. The CTCC subsequently sends the cost information back to the CPA.⁷⁵

Exhibit 4.2: Scenario 2



Source: Customized Tours Components Coordinator (2006-11-14)

4.2.3. Scenario 3/4/5

Often, the customized tour includes new activities and alternate airports, which are not a part of a standardized tour. In those cases, costs do not exist in the Program System.⁷⁶ In order to find costs for the new activities the CTCC contacts the representative from Land Operations responsible for the specific geographic region (D in *Exhibit 4.3*). Land Operations search for and contact suppliers, trying to find cost information for the activity. The time spent by Land Operations searching for and contacting suppliers varies greatly depending upon the complexity of the request.⁷⁷

⁷⁵ Customized Tours Components Coordinator (2006-11-14)

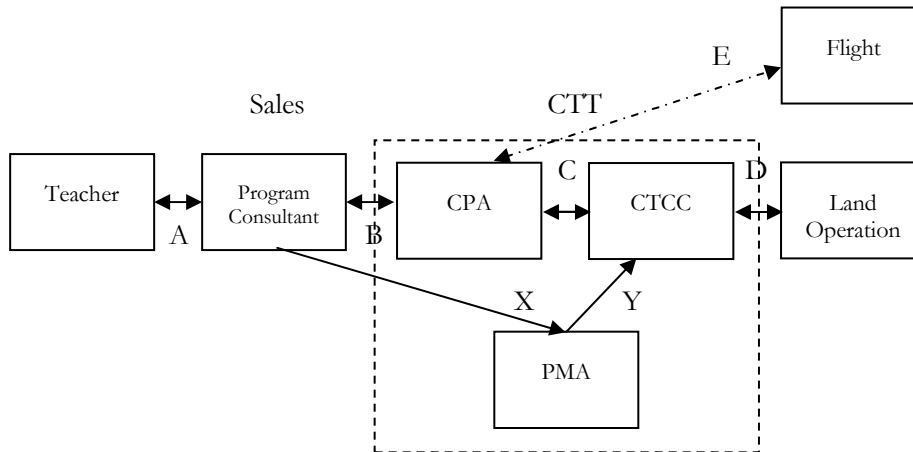
⁷⁶ Custom Pricing Administrator (2006-11-15)

⁷⁷ Senior Sales Executive (2006-11-14)

In those cases that the request includes an alternate airport, the CPA contacts Flight (E in *Exhibit 4.3*), which handles the request and forwards the cost information. The time spent by Flight varies depending upon the complexity of the request.⁷⁸

Our *Scenarios 3, 4 and 5* differ greatly in their level of complexity and thereby also time consumption. We divide the scenarios into three separate scenarios in order to emphasize that there is a difference in time consumption between the three even if the work flow *per se* might be unchanged. In other words, all requests in *scenario 3, 4 and 5* go to Land Operations, however, the time consumption relationship between Scenario 3:4:5 in Land Operations could be up to 1:12:60⁷⁹ due to the differing complexity of the request.⁸⁰ All requests in the three scenarios might also go to Flight and in similarity with Land Operations, the time consumed handling different requests does differ in *scenario 3,4 and 5*, however, not to the extent as in Land Operations.

Exhibit 4.3: Scenario 3/4/5



Source: Customized Tours Components Coordinator (2006-11-14), Senior Sales Executive (2006-11-14), Vice President-Flight (2006-11-17)

⁷⁸ Vice President-Flight (2006-11-17)

⁷⁹ The time required by Land Operations to handle a tour request of low complexity amounts to approximately 20 minutes, handling a tour of medium complexity requires approximately 4 hours and handling a tour of high complexity requires approximately 20 hours

⁸⁰ Senior Sales Executive (2006-11-14)

4.3. Cost Accounting

The Travel Company uses a three-step model to calculate the final sales price. Firstly, direct land costs are calculated, consisting of all costs for the students and the teachers while in the country of visit. These costs consist of for example hotel costs, meals, tour director, tour bus and entrance fees. Secondly, direct flight costs are calculated, consisting of the price of the flight tickets. The flight costs are normally independent of the number of travelers. The flight costs and land costs are always multiplied with 7/6 so that the participants traveling for free are paid for⁸¹. Thirdly, a margin⁸², based on the direct land costs, is added to the total direct costs. Previously, The Travel Company added a fixed percentage margin to the direct land costs.⁸³ However, the company recently introduced a new method to calculate the margin.

4.3.1. Calculating the Margin

Today, The Travel Company uses the formula in *Equation 4.1* to calculate the per person margin for the standardized tours.⁸⁴ As can be understood by *Equation 4.1* the margin in USD will increase as direct land costs increase. However, independently of the number of travelers, length and destination, standardized tours require approximately the same amount of time to handle, with a deviation of only approximately 10–15 per cent.⁸⁵

$$\text{Margin per person (USD)} = Z + Y \cdot (\text{Land Costs})^x \quad (\text{Equation 4.1})$$

Z in *Equation 4.1* represents a season- and competition-dependant variable. Popular departure dates are more aggressively priced and the hostile competition situation in certain regions demands lower prices.⁸⁶

Y is a figure derived by The Travel Company through approximations with the objective to end up with an appropriate margin expressed as a percentage of the final sales price. Y is not altogether fixed but may be raised for certain departure dates.⁸⁷

⁸¹ When a teacher recruits 6 students the teacher gets a free tour seat

⁸² Indirect costs plus profit

⁸³ Custom Pricing Assistant (2006-11-15), Customized Tours Director (2006-11-14), Yield Manager (2006-11-14)

⁸⁴ Customized Tours Director (2006-11-14). The exact numbers in the margin can not be shown due to the industry's competitive environment

⁸⁵ Senior Sales Executive (2006-11-21)

⁸⁶ Yield Manager (2006-11-14)

The company's profitability is assessed on a percentage basis, as illustrated in *Equation 4.2*. Nevertheless, the per person USD margin amount is also considered important and focused upon.⁸⁸

$$\text{Margin per person (\%)}^{89} = (\text{Indirect Costs} + \text{Profit}) / \text{Final Sales Price} \quad (\text{Equation 4.2})$$

$$\text{Margin per person (USD)} = Z + Y \cdot (\text{Land Costs})^x$$

4.3.2. Calculating the Margin for Customized Tours

When pricing customized tours The Travel Company simply adds a customization fee, as showed in *Equation 4.3*.

$$\text{Margin per person (USD)} = Z + Y \cdot (\text{Land Costs})^x + \text{Customization fee} \quad (\text{Equation 4.3})$$

When initially deciding upon the size of the customization fee, the objective was to cover the costs of CTT.⁹⁰ The specific customization fee chosen in a particular case is rather arbitrary and depends on for example the perceived complexity of the tour and the amount is constantly compared to the margins of the standardized tours. The size of the customization fee is not directly related to the additional time required to handle a customized tour.⁹¹ In addition, customized tours normally incur higher land costs as a result of more expensive excursions and activities.⁹² However, the customized tours are usually made up of larger groups.⁹³ The direct land costs per traveler normally decrease as the number of travelers on a tour increases since each tour group requires a bus and a driver and with a larger group this cost is allocated to a larger number of individuals.⁹⁴

The Travel Company tries to have margins for the customized tours that do not differ too much from the standardized tours. Neither do they want the actual price paid for a customized tour to

⁸⁷ Yield Manager (2006-11-14)

⁸⁸ Customized Tours Director (2006-11-14)

⁸⁹ Standardized Tour

⁹⁰ Yield Manager (2006-11-14)

⁹¹ Customized Tours Director (2006-11-14)

⁹² Senior Sales Executive (2006-11-28)

⁹³ Regional Sales Manager (2006-11-17)

⁹⁴ The Travel Company Tour Fact Sheet (2006)

differ considerably from the price of a similar standardized tour. These factors are taken into consideration when deciding on the size of the customization fee.⁹⁵ Another important aspect when deciding upon the customization fee is the prevailing market prices for similar tours.⁹⁶ The customized tour's margin might be lowered in the case of a competitor offering a standardized tour which The Travel Company does not, a customized tour with the same content can thus be created, with a price that matches the competitor, in order to win the business.⁹⁷

The Travel Company is active on a competitive market and actively benchmarks its prices against competitors. Its objective is to end up in the same price range or lower than its competitors.⁹⁸ However, due to increasing competition and costs The Travel Company has been forced to lower margins and raise prices.⁹⁹

⁹⁵ Custom Pricing Administrator (2006-11-15)

⁹⁶ Vice President-Land Operations (2006-11-30)

⁹⁷ Customized Tours Director (2006-12-01)

⁹⁸ Chief Financial Officer (2006-10-12)

⁹⁹ Chief Financial Officer (2006-09-29)

5. Analysis

The purpose of this chapter is to analyze the theoretical frameworks and empirical results presented earlier. The company's current cost accounting system will be evaluated and its implications analyzed. Alternative costing methods and the implications of implementing such will also be discussed.

5.1. Implications of the Current Cost Accounting System

The cost accounting system presently used by The Travel Company bears some resemblance with the Direct Costing method. The Direct Costing method includes indirect costs in the costing through the contribution margin. The contribution margin resembles The Travel Company's margin; they are both set to include the indirect costs of the period as well as expected profit. Hence, the direct costs together with the contribution margin makes up the final sales price. The Direct Costing method is known to be particularly suitable if the sales price of a product is given by market forces. As The Travel Company is active on a competitive market and highly aware of the competitors' prices, which they also use as a benchmark when setting prices, the sales price can be said to be, to some extent, set by market forces.

However, The Travel Company's cost accounting system can also be said to resemble the Full Costing method. As the Full Costing method predicts, the customized tours' part of indirect costs is simply added to the direct costs already calculated, by using direct land costs as a distribution key. Through the usage of this allocation method The Travel Company assumes that direct land costs and indirect costs are correlated which, in turn, implies that tours with high direct land costs incur high indirect costs. It could, however, be questioned whether direct land costs are actually the optimal distribution key for The Travel Company.

Transaction with customers may differ in complexity independently of the tour's direct costs. The time needed to resolve a customer request can vary greatly depending on the complexity of the situation being handled. Presently, a customer requesting a standardized tour with high direct land costs carries a high percentage share of total indirect costs although The Travel Company's handling of the tour might not be time consuming. Since the time required handling a standardized tour does not vary considerably and the indirect costs consist almost entirely of indirect labor costs, each standardized tour's incurrence of indirect costs should not differ significantly.

Simultaneously, a customized tour might incur low direct land costs while being highly complex and time consuming to handle. The Travel Company tries to take this into account through the customization fee. However, the size of the customization fee is a quite arbitrary amount that The Travel Company adds since the company is aware of the fact that the customized tours demand more

time than the standardized tours to handle. In addition, there is even a function solely handling the customized tours whose costs naturally need to be covered by the customization fee. Nevertheless, the specific amount added might very well not represent the true additional costs incurred by the customized tours since the actual time and effort needed to handle these tours in each function has never been investigated. The current cost accounting system results in an arbitrary cost allocation that might not reflect the true cost of the customized tours.

At present, some of the customized tours might even be so high in complexity that handling them to the current price incurs a loss. However, The Travel Company cannot know which ones of the tours, if any, that are not contributing with a profit. One of the reasons is that the margin added is based upon the direct land costs. The implicit assumption that the amount of indirect costs that a specific traveler of a customized tour incurs are directly related to the amount of direct land costs that that specific traveler incurs is quite arbitrary. Also, the customization fee added to the standard margin is not based upon any thorough cost calculations. When deciding upon the size of the customization fee The Travel Company attempts to obtain margins for the customized tours that do not differ too much from the standardized tours. To base the customization fee on this objective is from a cost accounting perspective unfounded since the customized tours' incurrence of indirect costs is not related to the fee. Another reason is that when The Travel Company evaluates its business it does so on the basis of a margin, incorporating both the indirect costs and the profit. In *Equation 5.1* we repeat the customized tours margin from chapter 4, expressed as a percentage of final sales price.

$$\text{Margin per person (\%)}^{100} = \underbrace{(\text{Indirect Costs} + \text{Profit}) / \text{Final Sales Price}}_{\text{Margin per person (USD)}} \quad (\text{Equation 5.1})$$

$$\text{Margin per person (USD)} = Z + Y \cdot (\text{Land Costs})^x + \text{Customization fee}$$

The Travel Company does not deduct the indirect costs for the specific tours and hence they do not know their specific profit margins. Even though this might not be the correct profit margins, due to possibly erroneous cost calculations, trying to separate the indirect costs from the profit would force The Travel Company to begin evaluating their cost structure and profit margins.

However, one must keep in mind that there might still be reasons for keeping time consuming and possibly unprofitable customized tours. Possible reasons might be to secure future business, increase market shares and build reputation. Customization means increased customer value and The Travel

¹⁰⁰ Customized Tour

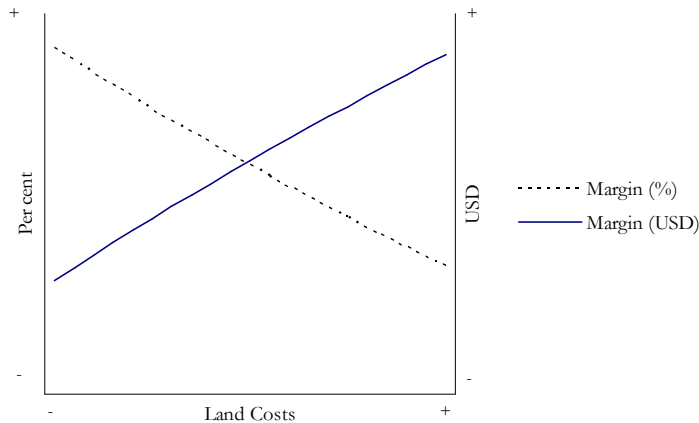
Company can in this way influence the customer's loyalty. However, on the other hand, the error frequency might be high due to the fact that the customized tours are often complex. This might result in high costs in the form of customer complaints and lost customer loyalty.

5.1.1. Implications of the Margin

When The Travel Company assesses the tours based on the USD margin the margin increases as the direct land costs increases and thus tours with higher direct land costs appear to be more profitable. However, when assessing the profitability based on the margin expressed as a percentage, the profitability decreases as the direct land costs, and thereby also price of the tour, increase.

Exhibit 5.1 illustrates an example of how the margin per person, in both USD and per cent, can relate to direct land costs. As illustrated in *Exhibit 5.1*, the margin in absolute terms increases as land costs increase while the margin calculated as a percentage of final sales price decreases as land costs increase.

Exhibit 5.1: Illustrative example of how margins relate to land costs



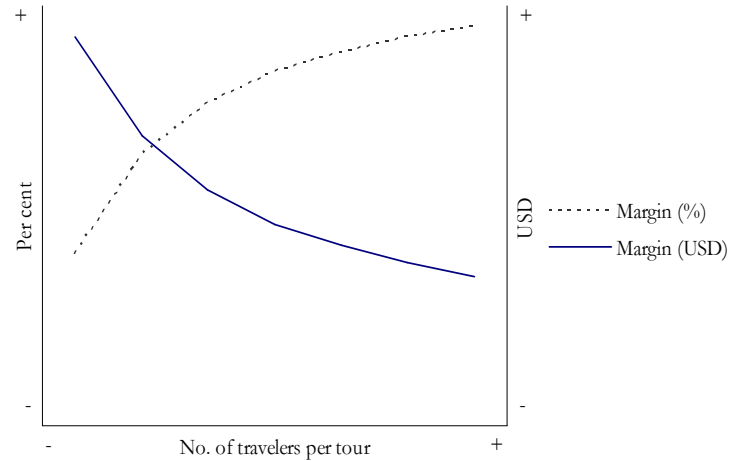
Note: The land costs, margins and final sales price used in the graph are not taken from an actual tour

Since customized tours often incur higher direct land costs than standardized tours it implies that customized tours could actually have lower margins in per cent. This difference is not necessarily covered by the customization fee.

The margins have an opposite effect when the number of travelers on a tour increases. As the number of travelers on a tour increases, the direct land costs per traveler on that tour decrease. The flight costs, on the other hand, normally stay constant independently of the number of travelers. *Exhibit 5.2* illustrates an example of how the margin per person, in both USD and per cent, can relate

to the number of travelers on a tour. When direct land costs decrease the margin in USD as well as the final sales price decrease. However, due to the relationship between the margin in USD and the final sales price, the margin in per cent increases.

Exhibit 5.2: Illustrative example of how margins relate to number of travelers



Note: The land costs, margins and final sales price used in the graph are not taken from an actual tour

This would imply that larger groups pay a higher margin, calculated as a percentage, than do smaller groups. This particularly affects customized tours since they often consist of larger groups than the standardized tours' groups. Hence, customized tours might on average be paying higher margins in per cent than standardized tours as a result of this. However, the margins are higher in this case for an illogical reason. Higher margins in per cent should not be a result of larger groups but a result of the fact that customized tours are more resource intensive for The Travel Company to supply.

5.2. Activity Based Costing

There are several reasons for why the implementation of an ABC system could be motivated in the case of The Travel Company. Firstly, a significant share of The Travel Company's costs is indirect. Thus, inaccuracies created by improper assignment of the indirect costs have a large impact on the price of specific tours. Secondly, The Travel Company sells several, often significantly diverse, tours of differing complexity level. Through an ABC system implementation the customized tours time consumption would become visible. An ABC system would make the possible pricing inaccuracies visible and could lead to improved pricing and tour portfolio decisions in The Travel Company.

5.2.1. Creating an ABC system

We will, as an illustrative example, create an initial flow from resources to activities through cost drivers to tours for Land Operations, according to the ABC system. Firstly, the major activities at Land Operations need to be identified. The main activities performed are: writing of e-mails, calling phone calls and searching the internet for suppliers.

In the next stage, the ABC system traces activity costs to different tours through cost drivers. We will evaluate the appropriateness of the three different categories of cost drivers normally used, transaction, duration and intensity in the case of Land Operations.

Transaction drivers count how many times an activity is being performed. If transaction drivers were applied to The Travel Company it would manifest as the number of phone calls called or the number of e-mails written. As previously discussed, the time needed to resolve a customer request can vary greatly depending upon the complexity of the situation being handled. In other words, complex situations might demand phone calls ten times as long as one which is easily solved. Therefore, despite its appealing simplicity transaction drivers would not be suitable in the case of The Travel Company.

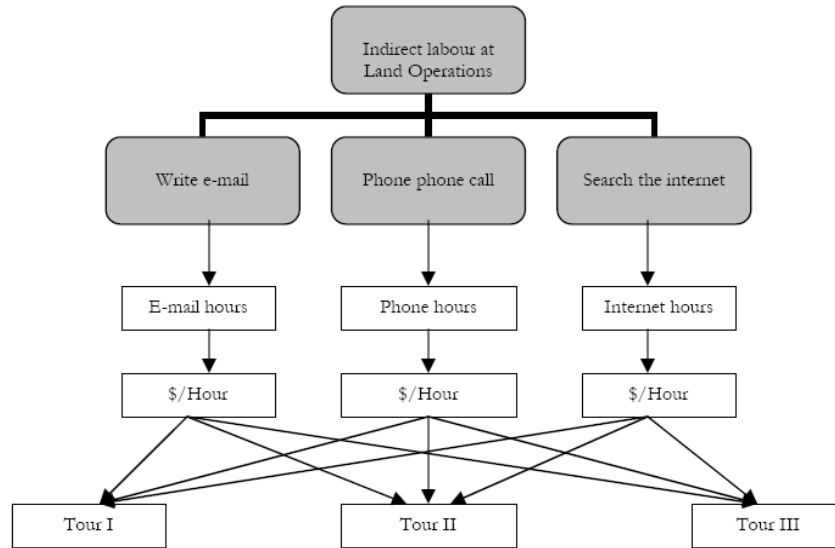
Since no customized tours, to any larger extent, require handling by professionals with special skills or expensive equipment, implementation of intensity drivers would not be appropriate. All personnel working operatively with the customized tours generally hold the same skill set.

The time required, rather than the number of different activities performed, is doubtlessly what drives the indirect costs studied in this paper. Hence, just as could be expected when the transaction with customers differ in complexity, duration drivers are highly suitable in the case of The Travel Company. Duration drivers correspond to the amount of time required to perform an activity, i.e. the amount of time required to call phone calls, write e-mails or search the internet. Since the costs incurred within Land Operations consist of labor costs we need to trace the total amount of time spent handling the customized tours in order to trace the costs incurred.

In the third stage, a cost driver rate is calculated and this rate is used to drive activity costs to specific tours. Since the cost driver in this case is the amount of time spent performing an activity, i.e. labor hours, and the total costs consist of labor costs, a suitable cost driver rate could be the hourly labor costs¹⁰¹. In *Exhibit 5.3* the expense flow in Land Operations is illustrated.

¹⁰¹ Including hourly salary, employer's contribution, insurance, and cost of facilities

Exhibit 5.3: Expenses flow from indirect labor at Land Operations to activities through cost drivers to tours



Our objective is not to carry out a thorough ABC calculation for The Travel Company but only to provide an illustrative example of how the flow from resources to activities through cost drivers to tours might be created. Therefore, the activities are only mapped out in one of the company's functions.

As can be interpreted from *Exhibit 5.3* cost drivers as well as cost driver rates are identical for the various activities. This will also be the case in the other functions studied in this paper. When a teacher requests a complex customized tour it leads to complex and time consuming activities in each one of the functions. Hence, it is, as in the case of Land Operations, the time required, rather than the number of times an activity is performed, that drives the indirect costs in each of the functions of interest. In addition, in none of the functions do the customized tours require handling by professionals with special skills or expensive equipment. Furthermore, virtually all indirect costs are directly related to the number of people employed in each function and their total salary, making hourly labor costs the appropriate cost driver rate.

5.2.2. Is ABC an Appropriate System?

Due to identical cost drivers and cost driver rates in the functions studied, the grouping of resource demanding processes into different activities is the only stage that would differ between them. Therefore, developing a thorough ABC system might not be necessary since the usage of duration

drivers does not have to be restricted to ABC. Also, the creation, implementation and follow-up of an ABC system is often complicated, time consuming and requires extensive information. In the case of The Travel Company, the indirect costs could be measured reliably with a simpler cost accounting system.

Also, a fundamental part of the ABC system is the handling of overcapacity. Overcapacity is never allocated but is instead accounted for as unallocated costs attributable to the cost center where it was incurred. It is not until overcapacity is taken into consideration that truly an ABC system has been created. In the case of The Travel Company there is no problem with overcapacity and total capacity equals practical capacity. Therefore, at present, the company does not need a complete ABC system.

5.3. Full Costing

The Full Costing method is less time consuming and complex compared to the ABC system. However, the allocation of all indirect cost through a percentage share has given rise to criticism. In the Full Costing method overcapacity is not taken into account since costs are not allocated on the basis of used resources but on the basis of total costs. However, as overcapacity is not an issue for The Travel Company, Full Costing could be an appropriate cost accounting system. Also, the usage of duration drivers does not necessarily have to be limited to the ABC system but might as well serve as a cost driver in the Full Costing method. The system would require an estimate of the duration each time an activity is performed.

As previously stated, The Travel Company could be said to already be applying a Full Costing method. However, the distribution key presently used, i.e. direct land costs, might not be closely correlated with the indirect costs. The Travel Company must distinguish what really is included in the indirect costs and what is actually driving them, i.e. their true cost drivers. Through the use of time as a cost driver, The Travel Company would acknowledge the difficulty of producing many different tours.

Since there are significant variations in time consumed in the handling of different customized tours, the allocation of indirect costs should reflect this variation. We suggest that The Travel Company conducts a thorough investigation of the time requirements for different tours. The survey should flow into a time-based classification of the customized tours with the objective to improve the allocation of indirect costs to tours. The indirect costs would become dependant upon the category in the classification system that the tour is placed in.

5.3.1. Time Measurement and Cost Allocation

In order for The Travel Company to create a time-based classification of the customized tours, the company needs to trace the time the tours necessitate. One potential way to trace the time is through the usage of a time measurement system.

Since each tour has a reference number and all tours are registered in the Program System, they can easily be found through searching the company's intranet. This established infrastructure could be used when creating a time measurement system. We suggest that The Travel Company adds a function in the existing Program System that enables the employees to easily enter their time consumption directly after a tour has been worked on. This function has to be easily accessible so that employees can, without difficulty, enter the reference number and register the time consumption for each and every stage of handling the tour. This function would continuously sum up the time consumed for each tour in every function. At the end of the tour the total time consumption in every function for the entire tour would be easily accessible. This information would enable The Travel Company to survey the time consumed for the various tours and functions.

All tour activities, suppliers and components throughout the tour are found in the Program System and would thus be directly connected to the time report. This would facilitate the understanding of what kind of tours and tour activities that might cause excessive time consumption and would provide a direct and easily accessible method for mapping out the reasons why the time consumption for some tours exceed others.

The information provided by the time measurement system should be analyzed with the objective to classify the tours. The number of different tour categories in the classification system will be dependant upon the variation of time consumed for different tours. However, with too many different categories the classification system would become complex and difficult to operate and follow-up on. The cost of operating such a system could exceed the benefits in terms of improved decisions made and only offer slightly more accurate information than would a relatively simple system. The goal should be to have a cost system that balances the cost of errors made from inaccurate estimates with the cost of measurement. With this in mind, a certain deviation in time consumption for different tours within the same category would have to be accepted.

5.3.2. Categorizing the Tours

When categorizing the customized tours, one option could be to use absolute time reported. If costs were allocated based on absolute time it would necessitate the total amount of work hours to be reported. For example, an employee working eight hours would each day have to assign all eight hours to the different tours handled during that day. A potential problem with this approach is that

employees might find it difficult to assign all work hours to specific tours. The reason for this is that even though a work day is eight hours long, the employees do not work continuously during all eight hours. As a result, the employees are forced to through approximations assign time to tours that has actually not been spent handling those tours. If not all hours would be reported and assigned to tours it would lead to unused resources, in the form of the employees' time, which would result in unallocated costs.

If instead costs were allocated based on relative time, this problem could be avoided since it does not necessitate that the total amount of work hours are reported. The time consumption of each category could be put in relation to the standardized tours. The standardized tours' time consumption might be calculated as the average of all standardized tours. The reasonableness of calculating an average of all standardized tours must be further investigated but according to an initial estimation by employees the time consumption for the standardized tours only deviates 10-15 per cent. This would indicate small differences in indirect cost incurrence between standardized tours. However, with this system there is an implicit assumption that the total amount of time is related exactly as the amount of time that actually has been reported. If this approximation would not be made, there would be unallocated costs since not all time is reported.

One consideration to have in mind when deciding on the appropriate way of categorizing is that both systems results in an approximate distribution of time. When evaluating which system to use The Travel Company would have to decide where in the organization that the approximation should be carried out. With the system based on absolute time the employees would be making the approximations, whereas with the system based on relative time, the controller function would be responsible for making the approximations. Both categorization systems would require that the time of the standardized tours is measured as well.

We suggest that The Travel Company implements a classification system with categories based on relative time. With the system based on absolute time the control of the categorization, through the necessary approximations, will to some extent be resigned from the controller function and transferred to the employees. We believe that through a system based on relative time The Travel Company would reach a more realistic time distribution. The system does not require that the employees assign time to a tour that has actually not been spent on that specific tour.

In *Table 5.1* an illustrative example of possible categorizations, based on differences in time consumption, is showed. The percentages indicate how large the time consumption of customized tour could be compared to the time consumption of the standardized tours in each function. The categories in *Table 5.1* do not correspond to the scenarios presented in the Empirical Findings

section. We identified the scenarios simply in order to illustrate how the work flow might fall out; and, the creation of a classification system would require thorough time measurement.

Table 5.1: Illustrative example of the time consumption of the customized tours in relation to the time consumption of the standardized tours

	Standard	Category 1	Category 2	Category 3	Category 4	Category 5	Category 6	<i>Average per division</i>
Sales Division	100%	110%	110%	115%	130%	175%	200%	128%
Land Operations	100%	100%	100%	120%	150%	320%	430%	158%
Flight Division	100%	105%	110%	120%	140%	175%	225%	130%
<i>Average Customized Tour</i>	100%	105%	107%	118%	140%	223%	285%	139%

Note: The percentages are not in any way based on true time consumption calculations but their objective is solely to show an illustrative example of how the time calculations could look

The percentage figure in the bottom right corner, 139%, indicates the total average for all customized tours in this example

Following from the discussion regarding the need for balance between the cost of errors made from inaccurate estimates and the cost of measurement, categories 1,2 and 3 in *Table 5.1* could probably be summed up to one single category, due to the small deviations between them.

CTT's costs are attributable to the customized tours. Therefore all of the costs incurred in that function could be allocated based on the relative percentage share of time consumed handling the tours of various complexity. See *Table 5.2* for an illustrative example.

Table 5.2: Illustrative example of cost allocation within CTT

	Category 1	Category 2	Category 3	Category 4	Category 5	Category 6	<i>Total</i>
Time in hours per tour	4	7	11	18	25	35	100
Percentage share of total	4%	7%	11%	18%	25%	35%	100%

Note: The percentages are not in any way based on true time consumption calculations but their objective is solely to show an illustrative example of how the time calculations could look

The time would have to be measured each time a request for a customized tour is made, in every function concerned and throughout the tour; from the first price suggestion request until the end of the tour. Through the measuring of time The Travel Company would be able to trace the time consumption for each specific customized tour. In the next stage, this information should be used to

create the classification system. Lastly, the time should be converted into indirect costs and allocated appropriately based on the chosen upon categories.

The variation in the time consumption and thus costs for different tours would become evident. The Travel Company would gain a better understanding of which tours that are contributing the most to the company's profit and which ones that should be rejected or re-negotiated.

Measuring the time would in The Travel Company's case be a completely new assignment since the time usage has never before been investigated. Hence, the employees have never reflected upon their time consumption which can make the time tracing more complicated. The initial phase of the duration driver tracing and implementation might be time consuming and resource demanding. Being a new experience, time tracing might also raise resistance among the employees. They might feel that management does not have trust in their work moral and efficiency. This would naturally further complicate the time tracing and therefore it is crucial that there is support for the tracing of time and that the employees understand its purpose.

The classification system, and the cost accounting system that would follow, would permit The Travel Company to do cost follow-ups and profitability assessments. It would show which tours incur the highest costs and in which of the specific functions the largest part of the costs arise and it would facilitate pricing and tour portfolio decisions.

5.4. Managerial Implications

The Travel Company has experienced high growth in the last few years and predicts continued steady growth for the forthcoming years. This will most likely result in The Travel Company having to handle customized tours of increasing complexity, requiring an increased focus upon cost follow-up and profitability assessment. The Travel Company has grown from a small to a middle-sized company and continues growing in size both organically and through acquisitions. The need for cost accounting systems and routines differ in companies of different size and in different phases. The Travel Company's management accounting system has not developed in the same pace as the rest of the company and there is an evident need for The Travel Company to acquire a better understanding of their costs and routines. It is also important that the employees are given clear guidelines regarding what amount of time that is reasonable to spend on a single tour. These guidelines could be created through the profitability analysis that the time measurement system would enable. Moreover, since the implementation of the time measurement system might raise resistance it is crucial that management convincingly emphasize that the employees will not be evaluated on the basis of it.

The Travel Company's current cost accounting system is easy to use in the sense that there is an easily applicable margin which can be adjusted for each tour. Also, from a customer perspective it

might be easier to comprehend and accept a higher margin in absolute terms for an expensive tour and vice versa, than a margin based on the degree of complexity of the request. Changing cost accounting system is demanding, takes time and might be costly. A problem in this respect is that it might be easier for management to keep a cost accounting and pricing system which is well received by customers and which results in competitive prices. However, we believe that it is essential for the company's future prosperity that management understand the tours' cost structure and cost drivers. This information should consequently shape the future plans and decisions that the company makes.

Implementing a controller function could be a way to approach a superior management accounting system. The controller could initially be responsible for the time measurement and would greatly improve The Travel Company's cost follow-up and profitability assessment.

6. Concluding Discussion

In this chapter the findings of this study are summarized. Concretely, this chapter answers the research questions stated in the beginning of the study.

6.1. Summary and Conclusions

The Travel Company offers its customers the option to completely customize their tours. The customized tours are more complex to handle than the standardized tours since they can include new activities, excursion, hotels and destinations. To calculate the final sales price of its tours The Travel Company firstly calculates their direct costs and subsequently adds a margin incorporating all indirect costs plus a profit. The direct costs consist of direct land costs, i.e. all direct costs the travelers incur while in the country of visit, and direct flight costs, i.e. the cost of the flight ticket. The indirect costs primarily consist of labor costs for the different functions in The Travel Company. The margin, i.e. indirect costs plus profit, is calculated as a per person USD amount and is based on the size of the direct land costs. When calculating the price for a customized tour The Travel Company adds a customization fee to the standard margin.

This way of calculating margins presupposes that the indirect costs increase for a tour as the direct land costs increase. However, the complexity of the handling of a tour might differ independently of the direct land costs of the tour. Since The Travel Company is aware that the customized tours demand more resources than the standardized tours the customization fee is added to the margin. However, the size of the customization fee is arbitrary and not based on any thorough cost calculations. Due to the fact that the margin is not based on actual resource usage but direct land costs and since the margin is not based on thorough cost calculations, it is difficult for The Travel Company to make well founded pricing and tour portfolio decisions.

The time needed to handle the customized tours varies significantly depending on the complexity of the tour and virtually all indirect costs are directly related to the number of employees and their total salaries. Because of this we suggest that The Travel Company bases their indirect cost calculations on time consumption instead of direct land costs.

This could be done through the implementation of a time measurement system. The employees would have to assign their time to different tours. The time measurement system would enable the creation of a classification system where the customized tours would be categorized depending on their time consumption. The tours' indirect costs would be allocated on the basis of the different categories.

The classification system could either be based on absolute time or relative time. A classification system based on absolute time necessitates that the employees assign their total amount of work hours to different tours. A relative system does not necessitate that the employees assign the total amount of work hours instead they only have to assign the exact time that they have spent working on each specific tour. With the relative system the customized tours would be categorized based on their time consumption relative the standardized tours. We suggest that The Travel Company implements a time measurement system based on relative time since we believe it would result in more realistic time distribution.

A cost accounting system based on time would permit The Travel Company to improve their cost follow-ups and profitability assessments. It would make the customized tours' resource usage visible and it would enable better pricing and tour portfolio decisions.

6.2. Concluding Remarks

There are several reasons for why we have not chosen to conduct a thorough time measurement study and categorization ourselves. The amount of time at hand has been far too limited to enable a comprehensive time measurement study. A time measurement study would have required time and resources to travel to and visit all functions involved, spend time with the employees instructing them of the time measurement system's functions and objectives as well as an implementation of the system itself. Also, a large sample of different customized tours would be needed to ensure a proper categorization. To obtain such a sample takes time.

In this study we focused solely on the customized tours. However, we would recommend The Travel Company to allocate their indirect costs for the standardized tours on the basis of time consumption as well, as opposed to direct land costs.

7. Research Quality

In this chapter the quality of the study is reviewed. The internal and external validity as well as the study's reliability are discussed.

7.1. Internal Validity

Internal validity is concerned with the degree to which the results are an accurate reflection of reality and whether the researcher measures what is intended to be measured. According to Ratcliff there is no objective or universal way of guaranteeing validity, there are only various interpretations of it. One of the assumptions that qualitative research is based upon is that the reality is holistic, multidimensional and, constantly changing. There is no permanent and objective phenomenon waiting to be discovered, observed and measured. To solely focus on whether the information gathered is an accurate and exact reflection of reality is an inadequate way of measuring validity. What is studied is individuals' construction of reality, how they experience the real-world. Case study researchers try to seize and portray the phenomenon as it is experienced by the individuals in it. In a sense what seems to be true or what is experienced to be true is more important than what actually is true.¹⁰²

Merriam presents basic strategies that researchers can use to secure the internal validity of their research, for example: triangulation, participant control and horizontal review. *Triangulation* means that the researcher does not rely on one source of information but instead seeks complementing sources. *Participant control* means that participants in the study review the descriptions and interpretations made by the researcher and comment on whether the results concur with the information that the participants have tried to provide. Horizontal review means that the researcher asks other people review and comment on the study.¹⁰³

In this study we have used several sources of information. Besides the interviews, personal observations were collected of the employees and their work tasks. In addition, written material in the form of The Travel Company's Information Memorandum and catalogues have acted as complements to the interviews. Representatives from The Travel Company has read and approved the empirical content of the study. Also, friends have read and provided insightful comments regarding the results of the study. Through this, we have tried to strengthen the internal validity of the study.

¹⁰² Merriam (1994), p. 177 f

¹⁰³ Ibid, p. 179 f

7.2. External Validity

External validity is the extent to which the results of a study can be generalized to situations other than the one studied. Since qualitative research is concerned with understanding a certain problem rather than drawing general conclusions, generalization is considered weak in qualitative studies. It can be argued that there simply is no point in generalizing results from a single case that has been chosen for a certain purpose, instead of through randomness. According to Merriam the case study as a research approach is chosen when the researcher seeks to attain a high degree of understanding of a specific situation, person or event, not when the researcher tries to find something that is generally applicable.¹⁰⁴

However, certain measures can be taken in order to increase the external validity, and thus the generalization of a case a study. One prerequisite is that the researcher provides a detailed description of the context in which the study was conducted. The description must specify everything that the reader must know in order to properly understand the results.¹⁰⁵

In our study we have tried to increase the external validity through the provision of a thorough and comprehensive description of the context of the problem studied. However, our single case study cannot falsify or prove theory with any level of significance.

7.3. Reliability

Reliability is the extent to which the results from a study can be repeated. A high degree of reliability is attained when several independent studies of the same phenomenon provide the same results.¹⁰⁶ The reliability is also dependent on how objectively information is interpreted. This could be a weakness in qualitative studies since their main focus is to gain an understanding for the problem being studied, and consequently the researcher's own interpretations and perceptions of the information affect the results.¹⁰⁷

We have tried to ensure reliability in several ways. Interview protocols, included in Appendix I and II were used as guides for our respondent interviews. Through the usage of protocols we ensured structure and that each interviewee, within the same function, was asked the same questions. In addition, the theme of the study was described in the same way to all interviewees. Also, the objectivity of information interpretations was strengthened through the fact that both interviewers

¹⁰⁴ Merriam (1994), p. 183 f

¹⁰⁵ Ibid, p. 187 f

¹⁰⁶ Ibid, p. 180

¹⁰⁷ Holme & Solvang (1997), p. 94

were present during all interviews, including the phone interviews. After each interview notes were compared and complemented and when interpretations differed the tape recording was listened to.

In our presentation of the findings we have tried to maintain as objective as possible. Nevertheless, since the information is interpreted through us, it is inevitable that parts are subjective.

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9. Appendix I – Interview Protocol Sales, CTT, Land Operations and Flight

How many people work in this function?

What do your work task consist of? Major activities on regular basis?

Would you please describe – as detailed as you can – your work tasks involved when handling a customized tour?

Are all personnel involved in the handling of the customized tours?

How does the work flow look like in the organization when a customized tour is handled?

What determines how long time it takes to process a tour request?

Does it matter if it is a small or a big group (volume driver)?

Or what kind of customized tour that is ordered (duration or intensity driver)?

How long time does it take to handle different requests?

What percentage of your time would you estimate that you devote to the handling of customized tours?

Do some tours require more time than others? How much time does different tours require?

What type of tours require the most time?

How many per cent of the customized tour requests do you have to pass on to another function?

What types of tours do you have to pass on to another function?

10. Appendix II – Interview Protocol Yield Manager, CTT

Could you please describe how costs are calculated for The Travel Company's tour?

Could you please describe how prices are set for The Travel Company's tours?

Could you please describe how the margin is calculated?

Why is the margin calculated the way it is?

What distribution key is used when indirect costs are allocated?

Why is that particular distribution key used? What is the logic?

How is the additional indirect costs incurred by the customized tours accounted for?

How is the size of the customization fee decided upon?

Has the amount of time spent handling customized tours ever been investigated?