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Tots R Us

Introduction

Tots R Us (TRU) had been running a small, for-profit preschool program for young children between the ages of two and four for several decades. TRU was one of several privately run programs in the suburban Boston area. For each of the three age groups (i.e., two-, three- and four-year olds), there were two classes per day for a total of six classes in the facility each day. The classes were held both in the morning and in the afternoon, five days a week between September and June; there were approximately 200 days (40 weeks), or 1,200 class meetings, per year.[1] Only about one-third of TRU's local competitors offered classes during the summer months. The morning classes ran from 9:00 a.m. to noon, and the afternoon meetings ran from 1:00 p.m. to 4:00 p.m. Lunch was not served in either class. However, each class served a snack to the children. Class size varied from nine to 15 students per class. Although there was a lot of pressure from parents to reduce class sizes, a recent article in an industry newsletter showed that, given current demographics, the market for such programs could increase by 10% a year for the next five years.

The year before, a parent suggested that the school begin hosting birthday parties on the weekend. Since TRU's three classrooms were empty during this time, it seemed like a good use of the space and could generate additional revenue. Over the past year, the school had managed to quickly build a sizable side business hosting birthday parties. Approximately 150 parties were held in the school's three classrooms on Saturdays and Sundays throughout the year. The parties were typically attended by 10–20 children and ran for approximately four hours. The four-hour running time included the time necessary to set up and clean up the facility. For this service, the school's main competitors consisted of children's gyms, arts and crafts stores, and museums. Each had been offering specialized birthday parties for many years and charged very high prices. As a result, TRU was able to significantly underprice these other firms while maintaining a very high profit margin. In fact, due to the success of the birthday parties over the past year, TRU wanted to expand this business. TRU was considering switching the bulk of its advertising campaign from one that was designed to build general awareness of the school to one that was specifically directed at promoting the birthday party business.

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[1] Each day there was a morning class and an afternoon class for two-year olds, another morning and afternoon class for three-year olds, and a morning and afternoon class for four-year olds.

Professors Tom Fields and Susan Kulp prepared this case. HBS cases are developed solely as the basis for class discussion. The company mentioned in the case is fictional. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

Current Cost System

TRU's largest expense was related to the building (see **Exhibit 1** for an income statement). TRU had initially purchased a single-family home and converted it to a daycare/schoolhouse setting. The house cost $400,000, including $50,000 for the necessary renovations and license applications. Building-related expenses included depreciation, utilities, maintenance, cleaning, property taxes, and so forth. Traditionally, these costs were assigned to the classes on a per class-meeting basis. The building-related costs had not significantly changed since the introduction of the birthday party business. Therefore, no building-related costs had been assigned to the new product.

Salaries, supplies, and food were also allocated based on the meeting, where a meeting was either a single class meeting for three hours or a single birthday party for four hours. The actual cost of supplies and food for all of last year's birthday parties was $3,000; the actual cost for the preschool classes was approximately $18,000. TRU had five employees—three full time and two part time. The school's director earned $50,000, taught two of the preschool classes each day, and administered both the preschool and the birthday party programs. She spent approximately 20% of her time in administration, evenly split between the two programs. The remaining two full-time employees earned $20,000 per year and taught the other four preschool classes. Finally, TRU had hired two part-time employees to run the birthday parties on weekends, and each earned $5,000 per year. The director had approximately 20 years of daycare and teaching experience, the full-time teachers each had approximately five years of teaching experience, and the part-time employees were college students majoring in child development or education.

As advertising was used to build awareness of TRU's presence in the community and affected both products, it was not allocated to either product.

Pricing

TRU charged $200 for each birthday party, regardless of how many children attended, and averaged a total of about $270 for each preschool class session, depending on the number of students in the class. This was an increase over fiscal-year 2003, when preschool charges totaled only $240 per class session, even though average class size declined from 12 to 10 students.

Each year, TRU management prepared a budget for the next year that was exactly equal to the prior year's actual results.

Further Changes

Currently, the children's day was split up between a two-hour core class and a one-hour elective. The elective aimed to bring new ideas and teaching styles into the classroom. However, TRU believed that its core competency lay in delivering a solid, core class to the children. This method had been successful in preparing children for the move to kindergarten. Additionally, the elective had not been successful as an experimental setting to test new teaching styles and ideas; in fact, the elective had become merely an extension of the core class. Consequently, TRU planned to abolish the elective class and only offer the standard, core class.

Additionally, TRU was considering purchasing a neighborhood school. As part of the expansion, TRU's director would have more administrative responsibility. She had hired another teacher to cover her classes as well as two administrative assistants to help with the daily operations of TRU.

Questions

1. Compute the cost of a single preschool class and a single birthday party using the current cost system.

2. Would you recommend that TRU continue to allocate the building-related costs only to the preschool program? What alternative allocation method would you suggest? Justify your answer. Ignore consideration of excess capacity discussed in question 3 below for this answer. Please discuss any additional information that you feel is needed.

3. For three months each year (June–August), the school building is largely unused except for the birthday parties. This represents approximately 60 days, or 360 additional classes that could be run but are not. How should TRU account for this excess capacity? Please explain why you recommend this method.

4. Do you agree with TRU's allocation method for salaries, supplies, and food? Why or why not? Be specific about any alternative allocation methods that you would consider.

5. Do you agree with TRU's decision not to allocate the cost of advertising? Why or why not? Be specific about any alternative allocation methods that you would consider.

6. Compute the cost per class meeting and per birthday party under the assumptions that you have made.

7. How could TRU use the information from the revised cost information to enhance profitability?

8. Briefly explain the change in the average revenues per class (from $220 to $230 per class between last year and this year). What other information would you collect to help explain the variation?

9. The board has an increased concern about maintaining control of TRU as it expands. Until now, it has not used a formal control system. What control systems, if any, would you suggest that it establish? Be sure to clearly explain your answer thoroughly.

Exhibit 1 Income Statement for Year Ended June 30, 2002

Revenue	$354,000
Building Related	$216,000
Salaries	100,000
Supplies and Food	21,000
Advertising	10,000
Net profit	$ 7,000

Source: Casewriter.