

some industry leaders to initiate action to define operating costs and control their rate of increase.

This ended when the oil supply exceeded demand in 1980-81 and many companies were forced out of business. Some might have survived had management been more skilled in business techniques and had access to industry economic information.

Since that time there has been a gradual recovery, an influx of new operators with business experience, and increased activity by HAI and individual industry leaders both to generate useful economic information and increase access to economic knowledge needed by operators. The industry has made a good start on improving the quality and quantity of economic information about the industry and the economic knowledge needed to make use of it.

## THE HELICOPTER INDUSTRY vs. DIRECT OPERATING COSTS

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### INTRODUCTION

The usefulness of cost information in manufacturing firms is widely documented. Without complete and accurate information a company cannot adequately plan, control, measure, or evaluate its performance. In a tight fiscal environment a company without good cost data will not survive over the long run.

During the last half of the 1970s and before the decline of oil prices and a resulting decrease in exploration activities, the helicopter industry was flying high with its operating income in a very positive position and cash flow looking very good. The helicopter companies had an overabundance of work, charging and receiving high fees. Companies were not concerned with their operating expenses as the revenues adequately covered the operating costs.

With OPEC's decrease in oil prices and the drastic reduction in oil exploration, many helicopter companies found themselves with fewer flying contracts and little revenue, yet still with costs to cover. When a job did become available, operators would compete for the opportunity to fly it. Unfortunately, many of the competing firms mispriced the bid because they did not know the true costs of flying the helicopters. Some of these companies still do not know their direct or indirect costs. The result has been that many have since been forced out of business.

According to David Smith, President, MBB Helicopter Company, "Understanding, measuring and expressing operating costs is the most important subject in the long-term survivability of our industry." Unfortunately his statement is too true. Most helicopter firms are living on a day-to-day survival budget. Short-run survivability is the name of the game. The concept of "low-balling" a bid price and winning contracts does not equate to future existence if operating expenses continue to exceed revenues.

### COSTS

All helicopter flight operating costs can be grouped into either *direct* or *indirect* operating costs. Caution must be noted because direct operating cost (DOC) is not the same thing as a direct cost to an accountant. A distinction is necessary in order to avoid confusion. Direct operating costs are those costs which can be specifically associated with operation of the helicopter.

Indirect costs are all those other costs necessary to run the business. Unfortunately, at times one cost may be a direct cost while at another time it may be an indirect cost. The identification of the type of cost will depend upon the circumstance and not whether it is a fixed or variable cost (explained later).

### INDIRECT COSTS

Indirect costs are sometimes referred to as *overhead*. Their estimation is extremely important and necessary when pricing a contract because rarely will an operation be conducted without it absorbing some overhead costs. In other words, every contract should include part of the total overhead. There is no other way to cover overhead except

through operations. As used in the helicopter industry, these costs usually consist of (1) facilities (including offshore fuel, radio network, base vehicles, hangars, etc.), (2) non-direct personnel costs (clerks, supervision, etc.), (3) shop overhead, (4) administrative, accounting, legal costs, etc., (5) marketing and advertising, and (6) management costs.

In small operations the burden of overhead can be very low, often as small as 5 to 10 percent of total labor and materials. In larger operations the overhead increases to 20 to 25 percent. The proper identification of overhead costs and application of these costs to each job/helicopter can make the difference between whether it would be cost-effective to fly a job at a certain price or not.

## **DIRECT COSTS**

Estimates of the direct costs of operating a helicopter can be categorized into two groups: (1) those items for which the manufacturer supplies information, and (2) those for which the operator supplies information. The manufacturer-supplied costs will be unique to the type aircraft being utilized. The operator-supplied costs will be unique to aircraft utilized, service provided, and other variations such as climate and other environmental conditions.

Manufacturer-supplied direct cost estimates have improved greatly in the past years with steps having been taken to standardize the formats used in presenting the costs and to increase visibility of the criteria and methods used in the estimation process. These costs are in two areas (1) fuel and lubricants, and (2) direct maintenance—including labor and parts. Generally, these costs are available to the owner-operator who must use them in conjunction with his own supplied information to plan for services his company will provide.

The operator-supplied direct costs have typically not been available in the small helicopter service company. The small company owner doesn't know his operating costs or doesn't know how to apply them to a service costing situation. Operator-supplied cost information generally consists of (1) crew costs (salary, employee benefits, travel and per diem, recruitment, payroll taxes, etc.), (2) insurance costs (hull, public liability and property damage, passenger liability, etc.), (3) depreciation, (4) maintenance, and (5) interest and finance expenses.

## **FIXED AND VARIABLE COSTS**

Two very distinct and important categories of costs are considerations in estimating and using operating costs. These categories are known as variable costs and fixed costs. They are relevant to both indirect and direct operating costs. DOC fixed costs are those costs whose total dollar value in a given period do not vary in proportion to the amount of some specified base—usually flight hours accumulated. Examples include insurance, crew costs, and depreciation. The fixed costs vary greatly when computed on a per-hour basis. These costs are generally operator-supplied and vary widely from one operator to the next.

DOC variable costs are those costs whose total dollar value in a given period vary in proportion to the flight hours accumulated. Generally, this covers maintenance and fuel. The variable costs vary little on a per-hour basis from one operator to another in the same geographic area and under the same operating conditions. These costs are normally manufacturer-supplied.

## **MANAGEMENT CONTROL**

A helicopter company is in business to provide a service at a reasonable price and receive an acceptable return on its investment. Management control, i.e., the process by which manager assure that resources are obtained and used effectively in the accomplishment of the organization's objectives, requires good cost data to assure success in meeting the company's goals. Normally management control is seen as a four-step process: planning, control, measurement, and evaluation. Each step uses operating cost data to meet its objective.

Step one is planning. It encompasses the goals and objectives of the organization—short-run as well as long-run. An example is a budget. A budget can cover a period of time (long-range or short-range) or a specific event (contract). As a minimum a one-year fiscal budget should be prepared based on the objectives of the company. The budget will provide an estimate of expected revenues and expenses based on management's best estimate of the services to be provided. The budget should be a "flexible" budget which is based on categorizing costs as to fixed versus variable. The budget can be adjusted as the time period elapses to keep pace with changing economic conditions. However, the relationship between fixed and variable costs and direct versus indirect costs must be known.

Step two—control—is vital to maintain accountability and profitability. Keeping track of costs will be vital for up-to-date information and comparability of actual to estimated results.

Information needs to be reported properly and in a timely manner to be useful. Use of a detailed chart of accounts detailing operating costs as direct or indirect will be helpful for reporting and evaluating later.

Step three—measurement—entails the proper generation of information which will be useful in the evaluation process. It requires the identification, collection, and proper recording of cost data. Thus, knowing what direct and indirect operating cost data are and how they relate to one another is important.

Step four—evaluation—requires comparison between the budget and actual costs on a time or contract basis. This will provide information as to variations above or below expectations. Knowing the true costs in relation to the budgeted costs allows management to modify future contracts, change prices, cut costs, pursue additional contracts, etc. This step cannot be delayed until the end of the year. It must be done continuously, otherwise the original goals and objectives may never be accomplished, nor can events be changed after they are initiated without costly consequences.

## REPORTING

The use of cost data is essential for the computation of company profitability. The typical income statement consists of:

$$\text{Revenues} - \text{Expenses} = \text{Net Income}$$

This can be recast into an income statement showing both types of expenses:

$$\text{Revenues} - \text{Operating Expenses (Direct and Indirect)} = \text{Gross Profit}$$

$$\text{Gross Profit} - \text{Other Expenses} = \text{Net Income}$$

From an investor standpoint this income statement will provide invaluable information about the company's ability to generate a gross profit from its normal operations.

Another kind of income statement is one that classifies costs as variable or fixed:

$$\text{Revenues} - \text{Variable Costs} = \text{Contribution Margin}$$

$$\text{Contribution Margin} - \text{Fixed Costs} = \text{Net Income}$$

From an internal standpoint this income statement will provide valuable information on the company's ability to meet its projections, ascertain whether its pricing structure is correct, or whether its costs are too high/too low to meet its profit goal.

Using variable and fixed cost data allows the management to calculate its breakeven point—that point at which its revenue is exactly offset by its costs:

$$\text{Revenue} = \text{Variable Costs} + \text{Fixed Cost}$$

or:

$$\text{Revenue} - \text{Variable Costs} - \text{Fixed Cost} = 0$$

The breakeven point (BE) can be computed on a time basis (year) or on a contract basis.

$$\text{BE} = \frac{\text{FC}}{\frac{\text{Revenues} - \text{VC}}{\text{Revenues}}}$$

Using this information and expected (budgeted) costs, management can change the components of the equation—cost, volume, and profits—and play a "what-if" game that essentially asks how a result will be changed if the original predicted (budgeted) values are not achieved. Further, with the numerous contingencies in the helicopter industry, such as unexpected maintenance repairs, it is wise to include a margin of safety in calculating costs, volume, and profit and comparing them to established goals.

## CONCLUSION

Timely and accurate measurement, collection, and evaluation of cost data are essential for the survivability of the helicopter industry. Operating costs must be accurately determined and can be an important element in the management control system of planning, control, measurement, and evaluation. The old adage "We'll make up for the decrease in profits by flying more hours" is not valid (and never was) if you don't know your costs. The benefits to the entire helicopter industry through better cost awareness are as significant as the danger of treating costs, and cost estimates, lightly. We don't fly into a thunderstorm, neither should we operate without knowing our true costs.

## ASSET MANAGEMENT: THE FIRST STOP IN FINANCING A CORPORATION

Richard Blakeley  
Smith-Barney

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### PREFACE

The owner of an air transportation company has many financial issues to keep a pulse on:

- Cash reserves needed,
- Amount of debt maintained,
- Return on assets,
- How to attract lenders,
- How to attract capital.

Unfortunately, many small to medium companies try to address the "how-to" issues before they address the cash flow issues. To address the issues from a different view, I wish to have the owner-operator step back and look at the business first from an organizational standpoint before addressing operations.

Many times in a smaller corporation the owner/president fills many positions in the organizational chart. The owner is the financial expert, flight operations manager, director of maintenance, and custodian. But the smaller the organization, the more important it becomes to have the right procedures in place to keep the company going when multiple tasks are to be accomplished.

### THE FINANCIAL AND LEGAL TEAM

Many corporations have little idea of what their cash flow needs will be over the next ninety days, let alone having laid out their cash flow needs for the coming twelve months. How many businesses have looked at last year's budget and compared it to last year's cash flow projections or actual cash flow? Were the cash flow charts developed for last year analyzed to see if any events were one time cash sponges, or are all events seasonal? Just because a corporation grows does not mean that the owner is a good business person or that the owner manages cash flow wisely.

To start with, a corporation should put together a good financial and legal team. The idea of building a financial and legal team should not sound like a term out of a management training book. The team should have qualified attorneys, CPAs, bankers, brokers, and corporate controllers. The team's goal should be:

To help grow and protect the corporate assets by development of policy and implementing those policies in a professional and ethical manner.

The team's charge is to work for the executive committee and the board of directors.

The lead person on the finance team is the equivalent of a Chief Financial officer (CFO). The CFO may wear several hats for the corporation, and probably will in a smaller corporation. The person who most often puts together the team is the CFO. The other positions a CFO may fill are corporate controller and the investment manager. At the corporate level, the important areas to control are: