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Fundamentals of Accounting and Financial Management

What You Will Learn

1) The Purpose of Professional Accounting
2) The Language of Professional Accounting
3) The Mechanics of Financial Management

Operator's Brief

In this chapter, you will begin to learn about the tools and procedures used to effectively manage a foodservice operation's finances. Professional accounting methods are the tools used to report and analyze the financial operation of a business. Users of professionally prepared financial information include both internal (business owners and operators) and external (lenders, investors, and government agencies) stakeholders. All will be interested in the financial performance of a foodservice business as reported using professional accounting practices.

There are several accounting specialties including financial accounting, auditing, tax accounting, cost accounting, and managerial accounting. The focus of this book is on managerial accounting: the process of using historical and estimated financial information to help those who manage foodservice operations better plan for the future of their businesses.

In addition to the operators of a foodservice business, there are likely others who require professionally prepared accounting information. These include owners, boards of directors, creditors, government agencies, employee unions, and financial analysts. Since so many entities are interested in the financial performance of a foodservice operation, it is recommended that the Uniform System of Accounts for Restaurants (USAR) be used to prepare financial information.

(Continued)

To be most easily understood, those responsible for business accounting in any industry use a consistent language to report financial results. These are called Generally Accepted Accounting Principles (GAAP), and they are utilized when providing information about a foodservice operation's revenues, expenses, and profits.

The mechanics of a professional accounting and financial management system include the three key components of bookkeeping, financial summary production, and financial analysis. Since transparency is important, those responsible for accounting in a foodservice operation must also recognize the ethical considerations of presenting financial information about a business.

CHAPTER OUTLINE

Professional Accounting

Some foodservice operators feel that **accounting** for their businesses is an extremely complex process. While professional accounting does require attention to detail, every foodservice operator can master the basic skills required to effectively record and analyze their financial results.

The term "accounting" actually originated from an old Middle French word *acompter*, which itself originated from Latin *ad* + *compter*, meaning "to count." Since all foodservice operators know how to count, they can master the most important accounting principles even if they do not consider themselves to be a professional **accountant**!

Key Term

Accounting: The system of recording and summarizing financial transactions and analyzing, verifying, and reporting the results.

Key Term

Accountant: An individual skilled in the recording and reporting of financial transactions.

Accounting for Effective Financial Management

The purpose of professional accounting is to report (account for) an operation's money and other valuable property. Professional accounting is utilized by all managers in business including those in the foodservice industry, and accounting principles are utilized every time a guest purchases food or beverages.

Accounting in a foodservice operation occurs even before the operation opens. Consider that operators estimate their initial costs before they decide to open their businesses, and they often seek loans from banks or others to provide them with funds needed to open their doors.

Those who consider lending money to a foodservice operator will want to know about the estimated financial performance of the business before they lend money to it. These potential investors will also want to know that any financial estimates presented to them have been professionally considered and prepared.

Professional and accurate accounting is important to many individuals in the foodservice industry. The owners of an operation will want to monitor their business's financial condition. These owners may be one or more individuals, partnerships, or small or very large corporations, but they all care about the performance of their investments.

Investors in a foodservice operation generally want to put their money in businesses that will conserve or increase their wealth. To monitor whether their investments are good ones, investors seek out and rely upon accurate financial information. When it is done properly, the professional accounting process provides that important information.

Professional accounting is actually a large field of study. To understand why accounting plays such a significant role in business, consider just a few examples of the type of basic and important questions the discipline of accounting can readily answer for foodservice managers:

1) What was the total sales level achieved by our business last month?
2) How many guests did we serve?
3) What was our most popular menu item?
4) What percentage of our revenue was achieved from sales of alcoholic beverages?
5) What **guest check average** was achieved last week? Was it higher or lower than the prior week?
6) What portion of our revenue is being spent on labor?
7) What percentage of our sales was achieved through our take-out and delivery services?

Key Term

Guest check average: The average (mean) amount of money spent per guest (or table) during a specific accounting period. Also referred to as "check average" or "ticket average."

8) Are our operating expenses higher or lower than those of other operations of a similar type?
9) Are we more or less profitable this month than last month?
10) What is our operation realistically worth if we were to sell it today?

The above are just a sample of the many questions hospitality managers utilize to answer accounting-related issues. However, it is important to understand that accounting is not the same as management. Rather, professional accounting is a tool used by effective foodservice operators to manage their businesses.

To better understand the difference between professional accounting and professional management, consider these examples of questions that are *not* best answered by using accounting information alone:

1) Should I promote Jenny or Raul to train our new dining room wait staff?
2) Should the portion size of the beef patty used to make our signature "Patty Melt" be 5 ounces or 7 ounces?
3) Would our guests prefer an increase in the number of inexpensive or higher-quality (but more costly) wines when we create our new wine list?
4) We currently close at 10:00 p.m. on Friday and Saturday night. Would we attract more customers if we decided to stay open an extra hour on those nights?
5) What are the best packaging materials to use for our carryout and delivery orders?
6) Should we assign someone additional hours to make more regular postings on our Facebook account? Who on our current staff is best qualified to perform this task?

Note that, in each of these questions, the best decision requires foodservice operators to utilize their own experience and best judgment of what is "right" for their guests, their employees, and their businesses. As a result, accounting alone cannot make the decisions called for in the questions above. It can however, when properly used, help operators make *better* decisions about these types of issues than those made by operators who do not understand how accounting could help them.

The purpose of this book is to teach operators how they can use accounting techniques and their own education, experience, values, and goals to make the very best management decisions for the businesses they manage.

Foodservice managers use properly prepared financial information to manage activities involving money that is earned and spent in the business. Financial information that summarizes these activities must be organized and expressed in meaningful ways. Analysis and interpretation of this data is necessary, and the results must be recorded, summarized, and reported to those needing to know about the economic health of the operation.

Users of professionally prepared financial information will be both internal (the business owners and managers) and external (lenders, investors, and government agencies). Financial management and professional accounting are not the same as **bookkeeping**, and there is a big difference between the two.

Key Term

Bookkeeping: The process of recording a foodservice operation's financial transactions into organized accounts on a daily basis.

Financial management includes organizing, analyzing, interpreting, recording, summarizing, and reporting financial information. By contrast, a bookkeeper's primary task is to analyze and *record* financial transactions. Note: In large foodservice organizations, a bookkeeper may handle only one type of transaction such as sales, accounts payable, or payroll. The organization's accountant would then summarize the bookkeeper's work and further interpret the results for the organization's owners and managers.

Accounting Specializations

As shown in Figure 1.1, there are several specialized areas within the accounting profession. In this section, we will explore details for each of the specialized areas.

Figure 1.1 Accounting Specializations

Financial Accounting

Financial accounting involves the overall process of developing and using accounting information to make good business decisions.

Financial accountants prepare financial statements including the income statement, balance sheet, and statement of cash flows all of which (and more!) are addressed in this book. These are among the most important reports that owners, managers, government agencies, financial institutions, and others use to learn about the current financial status of a restaurant.

Key Term

Financial accounting: The process of developing and using accounting information to make business decisions. It involves organizing and presenting financial information in financial statements and summaries, and its major focus is on the past.

To better understand how financial accounting can help foodservice operators, consider Tonya Richards. She is interested in starting her own small pizza shop. The shop would be located in a strip shopping center and would sell primarily pizzas, hot subs, and soft drinks. Some of the many financial considerations confronting Tonya as she tries to determine whether buying and operating the shop is a good idea include:

1) How much revenue do pizza shops like this typically achieve on an average day? An average month?
2) What do pizza shops normally spend to properly staff their stores?
3) How much should I spend on the equipment needed to prepare the menu items I will sell?
4) Given the size and location of my store, what is a reasonable price to pay for obtaining insurance for my business?
5) How much money am I likely to make for myself during the first year I own the store? How much in future years?

Tonya can get important information from her financial accountant, but she will also need managerial skills and her own intuition and talents to provide answers to these and other business questions she must answer.

Key Term

Auditing: The accounting specialty that involves studying a foodservice operation's internal controls and analyzing the basic accounting system to ensure that all financial information is properly recorded and reported.

Auditing

Auditing is an independent verification of financial records, and an **auditor** is an individual or group of individuals that completes the verification. The accurate reporting of financial transactions is important to many different

Key Term

Auditor: An accounting professional who specializes in auditing.

entities including managers, owners, investors, and taxing authorities. The auditing branch of accounting is chiefly concerned with the accuracy and truthfulness of financial reports. It is also concerned with safeguarding the assets of a business from those unscrupulous individuals who would defraud or otherwise take advantage of it.

Properly performed, the auditing branch of accounting is designed to point out accounting weaknesses and irregularities and help to prevent accounting fraud.

In part because of the potential damage that could be done by unscrupulous business operators, in 2002 the U.S. Congress passed the Sarbanes–Oxley Act (SOX). Technically known as the Public Company Accounting Reform and Investor Protection Act, the law provides criminal penalties for those who have committed accounting fraud. Sarbanes–Oxley covers a whole range of corporate governance issues including the regulation of auditors assigned the task of verifying a company's financial health. Ultimately, Congress determined that a company's implementation of proper accounting techniques was not merely good business. Instead, it would be the law, and violators would be subject to fines or even prison terms.

Not surprisingly, SOX has revised the role of auditors responsible for conducting an audit of a foodservice operation's accounting methods and techniques, and their role has become increasingly important. Individuals who are directly employed by a company to examine the company's own accounting procedures are called internal auditors, and they can play a valuable role in assessment because they usually understand the company's business so well. Note: External auditors (individuals or firms hired specifically to give an independent assessment of a company's compliance with standardized accounting practices) can also be retained.

Many foodservice operators serve as their own in-house auditors. If the facility they manage is part of a larger company or chain of units, their company may also employ in-house auditors. Auditors help to ensure honesty in financial reporting as they devise the systems and procedures needed to help protect and safeguard business assets. As a result, hospitality managers use auditors and auditing techniques to help address many internal questions including:

1) Are all our purchases supported by the presence of a legitimate invoice before we process payment?
2) Are any guest adjustments from their initial bill supported by written documentation explaining why the bill was adjusted?
3) Is all the revenue reported by our business fully documented and compared and matched to bank statements that list actual deposits made into the business's bank accounts?

4) Are wages paid to employees supported by a written and verifiable record of hours worked?
5) Do we have accurate records showing compliance with all requirements imposed by local, state, and federal taxing authorities?

The best auditors help ensure that financial records are accurate. They also assist operators in reducing waste and preventing fraud.

Find Out More

The 2002 SOX became law to help rebuild public confidence in how corporate America governs its business activities. The act has far-reaching implications for the tourism, hospitality, and leisure industries. To examine an overview of its provisions, enter www.sec.gov/about/laws.shtml in your favorite browser. When you arrive at the site choose "Sarbanes–Oxley Act of 2002."

Tax Accounting

Tax accounting is the branch of accounting that concerns itself with the proper and timely filing of tax payments, forms, and other required documents with the governmental units that assess taxes. Professional tax accounting techniques and practices ensure that businesses properly fulfill their legitimate tax obligations.

In the foodservice industry, all operators are required to implement systems that will carefully record any taxes that will be owed by their businesses.

Key Term

Tax accounting: The accounting specialty that involves planning and preparing for required tax payments and filing tax-related information with governmental agencies.

Cost Accounting

Cost accounting is the branch of accounting concerned with classifying, recording, and reporting a foodservice operator's expenses or costs. All businesses seek to control their costs and not waste their money, and those who manage foodservice operations are very concerned about their operating costs.

Key Term

Cost accounting: The accounting specialty that is involved with classifying, recording, and reporting a business's expenses or costs.

Cost accountants can determine costs by different departments such as the kitchen and the bar, by delivery service style such as dine-in or take-out, and by the guest services or merchandise sold by a business. They create systems to classify costs and report them in ways that are most useful to those who need to know how a business spends its money.

Find Out More

The control of costs is important to every business and especially so in the foodservice business. Professionals working in the foodservice industry have a variety of tools available to them to help manage their costs. One of the very best is the book *Food and Beverage Cost Control,* written by Dr. Lea Dopson and Dr. David Hayes, and published by John Wiley.

To review the contents of this extremely popular book, go to www.wiley.com. When you arrive at the Wiley website, enter *Food and Beverage Cost Control* in the search bar to examine the outline and content of this book's most recent edition.

Managerial Accounting

Managerial accounting is the specialty area of accounting that is the primary topic of this book. Managerial accounting is the specialization that helps managers make decisions about the future. To better understand the purpose of managerial accounting, assume that Mariana Gomez is the person responsible for providing in-flight meals to international travelers on flights from New York City to Paris. She manages a large commercial kitchen located near the John F. Kennedy Airport.

Key Term

Managerial accounting: The accounting specialty that uses historical and estimated financial information to help foodservice operators plan the future.

Mariana's clients are the airlines who count on her operation to provide passengers with tasty and nutritious meals at a per-meal price the airlines find affordable.

One of Mariana clients wishes to add a new daily flight beginning next month. The evening flights will carry an average of 500 travelers, each of whom will be offered one of two in-flight meal choices for dinner. The client would like to provide each flier with a choice of a beef or a chicken entrée. To ensure that the maximum number of fliers can receive their first choice, should Mariana's operation plan to provide each flight with 500 beef and 500 chicken entrées? (The answer, most certainly, is No!)

To prepare 1,000 meals (500 of each type) would indeed ensure that each traveler would always receive his or her first meal choice, but it would also result in the production of 500 wasted meals (the 500 meals *not* selected) on each flight. It would be difficult for Mariana to provide the airline with cost-effective per-meal pricing when that many meals are inevitably wasted.

The more cost-effective approach would be to accurately forecast the number of beef and chicken entrées that would likely be selected by each group of passengers and then produce that number. The problem, of course, is in knowing the optimum number of each meal type that should be produced. If Mariana had carefully and consistently recorded previous meal-related transactions (entrées chosen by fliers on previous flights), she would be in a much better position to use this information. She could, for example, estimate the actual number of each entrée the new passengers would likely select. If she had done so, she would be using managerial accounting.

Managerial accounting is the system of recording and analyzing transactions for the purpose of making management decisions of this kind. It consists of utilizing accounting information (historical records in this specific case) to make informed management decisions.

Managerial accounting is one of the most exciting accounting specializations. Its proper use requires skill, insight, experience, and intuition, and these are the same characteristics possessed by the best foodservice operators. As a result, excellent foodservice operators most often become excellent managerial accountants.

There are a number of different accounting specializations, and each is very important. These specializations are summarized in Figure 1.2. Foodservice operators may find that they perform some tasks in each of these specializations, or they may choose to employ individuals or organizations to help them. In all cases, each of the specializations in accounting can provide important information.

Users of Accounting Information

Foodservice operators are, of course, interested in the financial performance of their businesses and use the various specializations of accounting to assess that performance. However, foodservice operators are not the only ones interested in the financial performance of their businesses. There are other important users of accounting information.

Owners and Investors

Owners are those who have invested in the operation and may include one person in a sole proprietorship, two or more people in a partnership, or up to thousands

Specialization	Purpose
1) Financial	Record financial transactions
2) Auditing	Verify accounting data and procedures
3) Tax	Compute taxes due
4) Cost	Identify and control costs
5) Managerial	Make management decisions using accounting information

Figure 1.2 Specializations of Professional Accounting

of people in a corporation. All of these owners and investors will want to know how their investments are doing.

Boards of Directors

Large foodservice operations or multi-unit chains may have corporate stockholders who elect persons to represent them in the management of the business. These individuals need accurate accounting information to evaluate the effectiveness of the managers in charge of foodservice operations.

Creditors

Those who lend money (banks and other lenders) or who provide products and services (vendors and suppliers) will want to know the likelihood that the payment obligations of a foodservice operation will be met in full and on time before they agree to extend credit to the operation.

Government Agencies

Income earned by a foodservice operation is taxable by the federal government, most states, and many communities. For example, the Internal Revenue Service (IRS) at the federal level, state revenue departments, and local taxing authorities have an on-going interest in a foodservice operation's accounting records. Also, the Securities and Exchange Commission (SEC), a federal agency, must review audited financial statements as it approves prospective information developed by large restaurant organizations before they issue company stock to the general public.

Employee Unions

Some foodservice operations are unionized. Accounting information is used by union officials and members in unionized foodservice operations to assess the abilities of a business to meet wage and benefit requirements.

Financial Analysts

Persons outside of a foodservice operation such as staff members of mutual investment and insurance companies may desire accounting information about an operation for their own or a client's purposes.

The Uniform System of Accounts for Restaurants (USAR)

As noted above, many individuals and groups are interested in a foodservice operation's financial performance. Therefore, this information must be prepared in a manner that is consistent, easily read, and easily understood.

Laws exist requiring owners to properly report and pay taxes due to file certain documents with the government and to supply accurate business data to various other entities. As a result, many hospitality companies require that their managers use a series of standardized (uniform) accounting procedures. These are called a **uniform system of accounts** and simply represent agreed-upon methods of recording financial transactions.

Key Term

Uniform system of accounts: Accounting standards used to provide uniformity and consistency in reporting financial information.

Business owners use a uniform system of accounts to provide uniformity and consistency in reporting financial information about their businesses, and a uniform system of accounts provides accuracy, reliability, and comparability. The financial information produced using a uniform system of accounts will be verifiable and auditable by a third-party, and it will be understood by lenders, investors, taxing authorities, and others.

Different businesses have different accounting needs, and there are uniform systems of accounts produced specifically for individual business segments. In the hospitality industry, some of the best known of these uniform systems are the:

- ✓ **Uniform System of Accounts for Restaurants (USAR)**
- ✓ Uniform System of Financial Reporting for Clubs (USFRC)
- ✓ Uniform System of Accounts for the Lodging Industry (USALI)

Key Term

Uniform System of Accounts for Restaurants (USAR): A recommended and standardized (uniform) set of accounting procedures used for categorizing and reporting restaurant revenue and expenses.

Uniform accounting systems are continually reviewed and periodically revised. For example, this book was prepared using reporting principles contained in the eighth and most current edition of the USAR. Important specific recommendations of the USAR will be addressed in detail in the appropriate portions of this book.

To illustrate why the use of the USAR is so important, assume that an individual owned two Italian restaurants located in two different cities, and both offered the same menu. The owner wants to assess the ability of the two individuals responsible for operating the restaurants. It would be very confusing if the units' two managers used different methods for preparing and reporting each of their operations' financial results. In this example, unless managers both report and account for their financial performance in a way that is consistent (uniform), the performance of the two operations and their managers could not be properly analyzed and compared to each other.

The use of the USAR to produce accounting information for foodservice operations is not mandatory, but use of the applicable USAR is highly recommended. One reason is that a primary purpose of preparing accounting information is to clearly identify revenue, expenses, and profits for a specific time period. The best foodservice operators want to do this properly so the financial records of their businesses will accurately reflect their efforts.

What Would You Do? 1.1

"I know what Robert asked me to do, I'm just not sure how to do it!" said Sally.

Sally, the assistant manager at Chez Paul's French restaurant was talking to Otis, the restaurant's dining room manager.

"What's the problem?" asked Otis.

"The problem," replied Sally, "is that our manager Robert asked me to do the weekly inventory while he's on vacation. I'm supposed to count the items we have in inventory, multiply the amount we have on hand by the cost of the items, and determine our total inventory value."

"That seems easy enough," said Otis.

"Well the counting part is easy," said Sally, "and I know how to multiply. What I don't know is how much to multiply by. For example, we have 180 pounds of strip steaks in inventory. Some of them were purchased at $14 a pound and some at $18 a pound."

"So maybe multiply by $16 a pound?" questioned Otis.

Assume you were the owner of Chez Paul's. How important do you think it would be for inventory valuations produced by Sally to be calculated in the same way as those previously taken by Robert? What would be the likely result if they were not?

Generally Accepted Accounting Principles (GAAP)

The way operating statistics are compiled, and revenue or expense data is reported can be very significant to correctly interpret that data. Professional accountants in the foodservice industry use very specific principles to prepare financial information related to a business's revenue, expense, and profits and communicate results to others.

Those who read financial information must have faith that the collection and reporting systems used to prepare it are accurate and consistent. The information presented must also be easily understood. **Generally Accepted Accounting Principles (GAAP)** constitute the framework against which proper accounting procedures and techniques are measured.

Key Term

Generally Accepted Accounting Principles (GAAP): Standards that have evolved in the accounting profession to ensure uniformity in the procedures and techniques used to prepare financial statements.

Some of the most important GAAP in use and that directly affect foodservice operators include:

1) **Business entity:** This GAAP states that a foodservice operation is a distinct business separate from its owners. It generates revenue, incurs expense by using **assets**, and makes a profit, suffers a loss, or "breaks-even" by, and for, itself. This distinct business principle is important because it states a business's financial records cannot be combined with the personal financial records of the business's owners. This is true even if a single individual owns the business.

   The impact of this distinct principle occurs when income is measured as it is generated by the business, not when it is distributed to owners. Likewise, an obligation owed by the business is considered a **liability**. A liability may be money owed to a vendor to pay for products already received or as noted above, the liability may be an obligation such as loan to the business that the owners owe to themselves!

2) **Historical cost:** The value of a business asset is its agreed-upon cash equivalent. When a transaction occurs, for example, when an asset such as a piece of kitchen equipment is purchased, the price paid for it should reflect its **current fair value**.

   Over time, the value of an asset may change. For example, inflation may increase the value of land or buildings. However, the **historical cost**, not the current fair value, normally represents the asset's value in an operation's accounts and in its financial statements.

   To illustrate the historical cost principle, assume a building costs a foodservice operator $6,000,000 to buy. At the time of purchase, the cost would be equal to the building's current fair value. Three years later, however, the current fair value of the building may have gone up to $7,000,000, but the operator's financial statements would still reflect the historic cost of $6,000,000.

Key Term

Assets: Something of value owned by a foodservice operation. Examples include cash, product inventories, equipment, land, and building(s).

Key Term

Liability: Obligations (money owed) to outside entities. Examples include amounts owed to suppliers for delivered products, to lenders for long-term debt such as a mortgage, and to employees (payroll) that has been earned by, but not yet paid to, an operation's staff members.

Key Term

Current fair value: The measuring of a business's liabilities and assets at their current market value; the amount that an asset could be sold for (or that a liability could be settled for) that is fair to both buyer and seller.

Key Term

Historical cost: A measure of value used in accounting in which the value of an asset is recorded at its original cost when acquired by the company. The historical cost method is used for fixed assets under Generally Accepted Accounting Principles (GAAP).

3) **Going concern:** Accountants assume, unless there is reason to believe otherwise, that an operation will exist in the indefinite future. If, for example, the operation were to cease doing business, certain liabilities would be due immediately. Likewise, assets might need to be sold at a considerable loss. When accountants assume that a business will continue (and this is the normal assumption), there is no need to write down assets to a liquidation value or to reclassify long-term liabilities as being due immediately.

4) **Periodicity:** Periodicity, or the "time period" principle is important because it requires a business to clearly identify the dates for which its financial transactions are reported. For the owners of a business, it is likely that the most important financial reports they will examine are those that include all of the financial transactions occurring during their **fiscal year.**

   A fiscal year, which consists of 12 consecutive months (but not necessarily beginning in January and ending in December like a **calendar year**), would most likely include the business's best, as well as its poorest, periods of financial performance. A fiscal year-end financial report will provide owners with the information needed to file their taxes and perhaps make other needed financial management decisions.

   The amount of time included in any summary of financial information is called an **accounting period**. The managers of a business may be most interested in monthly, weekly, or even daily financial summary reports. These would inform the managers of the business's revenue and expense levels and profitability. The owners of the business would also be interested in such reports. Regardless of the report's readers, however, it is critical that the financial statements clearly state the time period they address.

   In some cases, the time period reported in a financial statement can be somewhat arbitrary. For example, consider foodservice operations that are open 24 hours a day, 7 days a week (the businesses never close). However, their managers must still select a point in time (usually between midnight and 5:00 a.m. when the operation will likely have the fewest financial transactions) to end the recording of one business day and begin recording the next day's financial transactions. In a properly prepared financial summary of any

Key Term

Fiscal year: A time period that can begin on any date and then concludes 365 consecutive days after it begins.

Key Term

Calendar year: A 365-day time period that begins on January 1st and ends on December 31st of the same year.

Key Term

Accounting period: The amount of time included on a financial summary or report, and which should be clearly identified on the financial document.

business, the periodicity principle assures that the reader will be clearly informed of the precise time period included in the summary.

5) **Expenses matched to revenue:** This GAAP requires that the **expenses** of a foodservice business be matched with and deducted from the **revenues** that are generated using an **accrual accounting system.** This accounting system recognizes revenues and expenses without concern for when cash is received or paid out by the business.

   In an accrual accounting system, money owed to a foodservice operation is called **accounts receivable (AR)**, and money owed by the operation to suppliers and others is referred to as **accounts payable (AP)**.

   Some very small foodservice operations may use a cash accounting system, which treats revenues as income when cash is received, and expenditures as expenses when cash is paid out. However, GAAP requires the use of an accrual accounting system, and this system will be the basis for the accounting discussions throughout this book.

6) **Consistency:** The consistency principle states that the same procedures used to collect and report accounting information are used each fiscal period. If this GAAP were not used, those who read about an operation's financial performance would not have accurate and uniform information upon which to base their decisions.

7) **Materiality and practicality:** The matching and consistency principles previously addressed require accountants using an accrual system to do their best to match a business's expenses with the time period in which those expenses were incurred. The materiality principle, however, allows accountants, under very strict circumstances, to vary from these two important principles.

Key Term

Expense: A decrease in a resource, such as food inventory, which occurs when a foodservice operation sells a product or service or incurs a business cost.

Key Term

Revenue: An increase in a resource such as cash, which occurs when a product or service is sold by a business. Also commonly referred to as "sales" or "income."

Key Term

Accrual accounting system: An accounting system that matches expenses incurred with revenues generated. This is done with the use of accounts receivable, accounts payable, and other similar accounts.

Key Term

Accounts receivable (AR): Money owed to a foodservice operation, generally from guests, which has not yet been received. Sometimes referred to as "AR."

Key Term

Accounts payable (AP): Money owed by the foodservice operation to suppliers and lenders that has not yet been paid. Sometimes referred to as "AP."

To better understand the reason for this GAAP, consider the foodservice operator who buys a $15 stapler for use in the operator's office. Assume that the stapler has an expected useful life of five years. In this situation, it could be argued that the operation's accountants should charge the restaurant's administrative expense account $0.25 each month for each of the next 60 months ($15.00 expense/60 months stapler life = $0.25 per month) to properly account for the stapler's expense.

The principle of materiality, however, states that in a case such as this, the amount of money involved is so small, the operation's accountants can expense the entire cost of the item in the same month it was purchased. To do otherwise would cause unnecessary work and would be unlikely to materially (significantly) affect the outcome of the operator's monthly expense statement.

The materiality principle, then, means that, if an item is deemed to not be significant, other accounting principles may sometimes be ignored when it is not practical to apply them. Stated another way, since businesses seek to make a profit, *it makes little sense to spend a lot of dollars accounting for a few pennies!*

The amount of money that must be involved before an expense is considered "material" can vary for each business and should be clearly identified. The amount of money expended before it is material should be unmistakably established by a business's owners, carefully applied to the business's records by its accountants, and freely shared with readers of the business's financial statements.

8) **Conservatism:** This GAAP requires that all business losses should be shown in financial records if there is a reasonable chance a problem will occur. Gains and related financial benefits, however, should not be reflected in financial records until they actually happen.

   To illustrate, assume a foodservice operation had a lawsuit for negligence filed against it, and the operation's legal advisor indicates the operation is likely to lose the lawsuit and can reasonably estimate the amount of the loss. The conservatism principle dictates the recording of the loss rather than waiting for the judge's decision.

   This principle is important since many accounting decisions do not have a single "right" or "wrong" answer. This principle guides accountants confronted with alternative measurements to select the option that will yield the *least* favorable impact upon the business's profitability and financial position within a specific accounting period.

9) **Objectivity:** While all GAAP have value, the objectivity principle most ensures readers of a business's financial statements that the documents will be reliable. Essentially, the objectivity principle states that recorded financial transactions must have a confirmable (objective) basis in fact. That is, there must be a way to verify that a financial transaction actually occurred before it can be recorded in the business's financial records.

To illustrate, assume a foodservice manager reported that a specific day's total sales equal $5,000. The objectivity principle states that these sales must have substantiating evidence to prove that they actually occurred. In this example, that evidence could include the individual guest checks used by wait staff to record guest orders, bank card statements showing charges made to guest's cards, or various sales records maintained in restaurant's **point-of-sale (POS) system**. In each of these cases, there is objective and verifiable records that confirm the restaurant manager's assertion that the day's sales equaled $5,000.

Key Term

Point-of-sale (POS) system: An electronic system that records foodservice customer purchases and payments, as well as other operational data.

In a similar manner, expenses must be verifiable before they can be recorded as having been incurred or paid. Examples of methods used to verify the recording and payment of invoices can include delivery slips or original invoices supplied by vendors, canceled checks, or documented electronic fund transfers (EFTs) showing that funds have been paid or moved electronically from the business to the entity to whom money is owed.

Additional types of verifiable expense evidence may include written contracts showing payments are due from the business on a regular basis. Examples of this type of verification include contracts spelling out the terms and length of lease payments or loan re-payments.

Recall that auditors are accountants who ensure that standards of financial reporting are maintained in a business. As a result, one of an auditor's main tasks is ensuring that businesses report only financial data that has a basis in fact. If businesses were allowed to estimate, rather than directly confirm, revenue and expenses, the financial summaries produced by these businesses would also be estimates. It follows, then, that these summaries would not precisely reflect the money earned and expenses incurred by the business. Not surprisingly, when auditors uncover significant accounting "scandals," it is usually a violation of this principle (such as a business reporting nonexistent revenues or inappropriately documenting its expenses) that generates the scandal.

10) **Full disclosure:** Bookkeeping and accounting most often report financial events that have happened in the past and simply must be recorded. For example, a lunch sale made by a Greek deli on Monday will be reported by the operation's management on Monday night. In a similar manner, a hospital

foodservice director who buys new hot food plate covers on the tenth of the month will likely summarize and report that purchase at the end of the month. Also, a food truck operator who replaces the truck's deep-fat fryer will, using appropriate accounting principles, record this expense over the useful life of the fryer (a time period that will likely span several years).

In each of these cases, when accountants rigorously apply GAAP, readers of the financial statements prepared for these businesses can have confidence that all transactions described have, in fact, been reported properly. The full disclosure principle, however, requires that accountants do even more.

This important principle requires that any past or even *future* event that could materially affect the financial standing of the business and that cannot be easily discerned from reading the business's financial statements must be separately reported. These reports, prepared in the form of footnotes, must be attached to the financial statements prepared by the business's accountants.

Accountants use full disclosure footnotes to report events that have not yet happened but could happen. And, if they do occur, they could considerably change the conclusions drawn by readers of a business's financial statements. Significant lawsuits filed against a business are just one example of a future event that must be revealed under the full disclosure principle. Other events affecting how financial statements are interpreted include changing from a cash to an accrual accounting system and significant tax disputes that occurred after the financial statements were prepared that could materially affect the business in the future.

Technology at Work

While very large foodservice operations will likely have a full-time accountant on staff or hire an accounting firm to assist them in producing their financial records, owners of smaller operations may elect to do all or most of their accounting themselves.

Fortunately, several companies have created accounting software programs specifically designed for foodservice operators. Using accounting software can help owners and managers know where their money is going and identify potential savings. The software can also track inventory and profits and properly calculate sales taxes to avoid fines.

To examine some accounting packages available to foodservice operators and learn about the costs associated with using them, enter "accounting software for restaurants" in your favorite search engine and review the results.

The Mechanics of Financial Management

As shown in Figure 1.3, the financial management of a foodservice operation consists of three key components. It is essential that all foodservice operators understand the purpose and importance of each component.

Bookkeeping

Earlier in this chapter, bookkeeping was defined as the process of recording a foodservice operation's financial **transactions** into organized accounts on a daily basis.

Key Term

Transaction: Any business event having a monetary impact on the financial statements of a business.

Proper bookkeeping forms the foundation of accurate financial reporting and analysis. It is not possible to make a meaningful analysis of a foodservice operation's financial standing if the data to be summarized was erroneously or carelessly supplied by those performing bookkeeping tasks. In addition, foodservice managers will not be able to properly analyze financial information and make correct decisions if the accounting information summarized was inaccurate.

To better understand the financial management process, consider that the recording of an individual financial transaction such as the sale of a cup of coffee is actually a bookkeeping task. It is typically completed by a server using an operation's POS system. An operator may then record the total number of cups of coffee sold in a specified time (accounting) period based on POS information. These sales as well as the other sales achieved by the operation will be summarized in

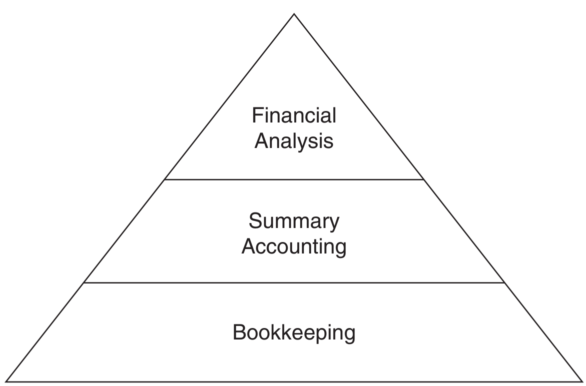

Figure 1.3 Mechanics of Financial Management

monthly financial statements to be analyzed by the operation's accountants, managers, and owners.

In the foodservice industry, the actual distinctions between bookkeeping and summary accounting are not always clear cut. Many foodservice operations are small, and bookkeeping, summary accounting, and financial analysis (managerial accounting) may all be done by only one or two individuals. For this reason, this book will not make a significant distinction between bookkeeping and accounting. For foodservice operators, however, it is important to ensure that precise and timely bookkeeping (recording) methods are used to produce the accurate financial data needed to make good decisions.

Summary Accounting

Foodservice operators should regularly create financial summaries of the transactions that have occurred in their businesses. The specific summaries created will vary based on the needs and desires of the business's owner. The following three major summary financial statements, however, are required under GAAP:

✓ Income statement
✓ Balance sheet
✓ Statement of cash flows (SCF)

The production of each of these three required accounting summaries (and more!) will be addressed in detail in the chapters that follow.

Financial Analysis

The regular and proper analysis of a foodservice operation's financial summaries are key to the operation's success. Foodservice operators frequently use a five-step process to analyze the financial performance of their businesses.

Step 1: Performance standards (expectations) are established. This is typically done through the development of an operating budget (see Chapter 8).
Step 2: Actual financial information is collected and summarized to measure operating results.
Step 3: Comparisons are made between expected performance (Step 1) and actual performance (Step 2).
Step 4: Corrective action must be taken when necessary to identify causes and bring actual results (Step 2) in line with the expected performance (Step 1).
Step 5: An evaluation of the results of corrective actions that have been taken (Step 4) is made.

Technology at Work

Due to the nature of their business, foodservice operations typically generate hundreds or even thousands of transactions a day. Recording these transactions and summarizing them creates a tremendous amount of financial data including guest payment information.

In some cases, a foodservice operator will elect to store all of that data on-site. Increasingly, however, the sheer volume of data generated requires extraordinary amounts of data storage capabilities. As a result, increasing numbers of foodservice operators are turning to the cloud for storing their financial information. Doing so has a number of advantages including 24-hour availability, heightened data security, accessibility from multiple locations, and low cost.

To examine some of the advantages of utilizing cloud-based storage for a foodservice operation's financial data, enter "cloud storage for accounting data" in your favorite search engine and review the results.

Ethics in Accounting

The foodservice industry is one of the most exciting and rewarding industries in the world. It will continue to offer its members solid employment opportunities and serve as the backbone of many local economies. However, the industry's reputation is partially built upon the knowledge that it is preparing and presenting its important financial information in a manner that is both legal and ethical.

Sometimes it may not be clear whether an actual course of action is illegal or simply wrong. Put another way, an activity (including an accounting activity) may be legal, but still be the wrong thing to do. It is important that foodservice operators be able to make this ethical distinction.

Ethics refers to the choices of conduct made by an individual in relationships with others. Most individuals would agree that "ethical" behavior refers to behavior that is considered "right" or the "right thing to do."

Key Term

Ethics: A system or code of moral rules, principles, or values.

Consistently choosing ethical behavior is important to a foodservice operator's long-term career achievements. One reason: Sometimes an operator will not know what the law requires in a given situation. When managerial activities are examined, employers, in many cases, will simply consider whether an operator's actions were intentionally ethical or unethical.

How individual foodservice operators determine what constitutes ethical behavior can be influenced by their cultural or environmental background, religious views, professional training, and personal moral code. Also, the definition of ethical behavior may vary based upon an individual's own perception of what is ethical.

While it may sometimes be difficult to determine precisely what constitutes ethical behavior, the five guidelines in Figure 1.4 can prove useful when an operator evaluates ethical implications of a specific accounting-related decision or course of action.

Bookkeeping and accounting are the two processes used to record and analyze a foodservice operation's financial performance. Regardless of how foodservice operators accumulate, sort, and retain their financial data, outstanding operators use managerial accounting information as they compile and analyze that data.

In the next chapter, we will closely examine the standardized accounting procedures used to create the important summary financial documents used by foodservice operators to evaluate alternatives to help them better understand and manage their businesses.

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1) **Is it legal?**

   Any course of action that violates written law or company policies and procedures is wrong.

2) **Does it hurt anyone?**

   Are benefits accruing to the operator that rightfully belong to the owner of the business? Discounts, rebates, and free products are the property of the business, not the manager.

3) **Am I being honest?**

   Is the activity one that can comfortably reflect well on an operator's integrity as a professional, or will the activity actually diminish their reputation?

4) **Would I care if it happened to me?**

   If an operator were the owner of the business, would he or she be in favor of their own managers behaving in the manner under consideration? If the operator owned multiple units, would it be good for the business if all unit managers followed the same courses of action?

5) **Would I publicize my action?**

   Perhaps the most important guideline is that of considering whether the action to be taken could be publicized. A quick way to review the ethical merit of a situation is to consider whom an operator would tell about it. If the operator is comfortable telling their boss about the considered course of action, it is likely ethical.

   If the operator would prefer that their actions go undetected, they are probably on shaky ethical ground. If an operator would not want their action to be read aloud in a court of law (even if the action is legal), then it likely should not be done.

Figure 1.4 Ethical Guidelines

What Would You Do? 1.2

Demario Davis was about to achieve his dream. Having finished his hospitality degree, Demario was ready to seek the financial backing he needed to open what he believed would be his first, but only the first, successful custom bake shop.

Demario was an experienced baker. With his educational background and solid industry experience behind him, Demario knew he had what it took to succeed.

To begin his project, Demario scheduled an appointment with the Small Business Administration (SBA) representative in his local area. Demario was meeting with the SBA to seek a federally backed loan that he needs to start his business. The SBA had asked him to bring his financial projections for the bake shop.

Assume you were the SBA representative meeting with Demario. How important would it be to you that Demario is knowledgeable and used GAAP to prepare the financial documents needed to apply for his loan? What would be your likely response if Demario did not understand and use such accounting principles?

Key Terms

Accounting
Accountant
Guest check average
Bookkeeping
Financial accounting
Auditing
Auditor
Tax accounting
Cost accounting
Managerial accounting
Uniform system of accounts
Uniform System of Accounts for Restaurants (USAR)
Generally Accepted Accounting Principles (GAAP)
Assets
Liability
Current fair value
Historical cost
Fiscal year
Calendar year
Accounting period
Expense
Revenue
Accrual accounting system
Accounts receivable (AR)
Accounts payable (AP)
Point-of-sale system (POS)
Transaction
Ethics

Operator's 10-Point Tactics for Success Checklist

Evaluate your need for, and the current status of, each of the following operational tactics. For those tactics you think are important, but not yet in place, develop an action plan for its implementation including who will be responsible for the tactic's completion and the target date by which it should be completed.

				If Not Done	
Tactic	**Don't Agree (Not Done)**	**Agree (Done)**	**Agree (Not Done)**	**Who Is Responsible?**	**Target Completion Date**
1) Operator recognizes that the purpose of professional accounting is the proper reporting of a business's financial results.	___	___	___		
2) Operator understands the key differences between accounting and management.	___	___	___		
3) Operator recognizes the main purpose of each accounting specialization.	___	___	___		
4) Operator knows the purpose of a uniform system of accounts when reporting the financial results of a business.	___	___	___		
5) Operator understands the advantages of utilizing the Uniform System of Accounts for Restaurants (USAR) when reporting financial results in a foodservice operation.	___	___	___		
6) Operator recognizes the need to use GAAP in the preparation of a business's financial records.	___	___	___		
7) Operator understands the important role of bookkeeping in the financial management of a foodservice operation.	___	___	___		

(Continued)

Tactic	Don't Agree (Not Done)	Agree (Done)	Agree (Not Done)	If Not Done: Who Is Responsible?	If Not Done: Target Completion Date
8) Operator understands the important role of summary accounting in the financial management of a foodservice operation.	___	___	___		
9) Operator understands the important role of analysis in the financial management of a foodservice operation.	___	___	___		
10) Operator understands the importance of ethical behavior when recording and summarizing a foodservice operation's financial performance.	___	___	___		