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INTRODUCTION TO FINANCIAL MANAGEMENT

MANAGER'S BRIEF

In this chapter you will begin the study of procedures to effectively manage and document your restaurant's finances. You will be introduced to the accounting process and its four specialty areas. In addition, you will see how the various users of accounting information will count on you to follow special accounting principles and practices that have been standardized for use by businesses in general and restaurants more specifically. As you use these specialized principles other businesses and government agencies that may be required to review your financial documents will be able to understand and use them.

There are several restaurant management and staff positions that may assist you in managing the money you earn and spend in your operation. This chapter introduces you to each of them and the important roles they can play in the financial management process.

Restaurant managers are not accountants; however, in this chapter you will learn how the financial control processes necessary for success are interrelated with the accounting process and the work of the accountant. Finally, you will review the characteristics of an effective working relationship among the restaurant manager, owner, and accountant.

If you own or manage an existing restaurant the accounting system is already established. It may be a cost-effective system that yields high-quality, usable information or it may be a less-than-adequate system that is not cost-effective. A new manager beginning work in the restaurant must know the basics of effective financial accounting systems to know, first, if the current system provides meaningful and helpful information, and second, what to do if it does not. Alternatively, if you are going to own or manage a new restaurant that is "on the drawing board," you may be asked for input on the design of the basic accounting system, or at least on the development of source documents and basic record-keeping procedures. If a system is being proposed (for example, by an accounting service you have hired for the task) you should be able to evaluate its potential worth to your new restaurant. Regardless, then, of the restaurant you will manage (existing or not-yet-opened), you will need to know about the standards that make up a good accounting system. A good restaurant manager must be aware of *what* is needed, *why* it is needed, *how* information can most effectively be collected, and *when* accounting-related activities must be undertaken.

FINANCIAL MANAGEMENT: WHAT IS IT?

FINANCIAL MANAGEMENT The process of organizing, analyzing, interpreting, recording, summarizing, and reporting financial information in ways that are meaningful for owners, managers, and other internal users and for lenders, government agencies, and other external users. Also referred to as accounting.

Restaurant managers use financial information to manage activities involving money that is earned and spent in the operation of their business. Financial information that summarizes these activities must be organized and expressed in ways that are meaningful. Analysis and interpretation of data is necessary, and the results must be recorded, summarized, and reported to those needing to know about the economic health of the restaurant. As will be seen, users will be both internal—owners and managers, for example—and external—including lenders and government agencies.

Financial management is *not* the same as **bookkeeping:** There is a big difference! Financial management includes organizing, analyzing, interpreting, recording, summarizing, and reporting financial information. By contrast, a bookkeeper's primary task is to analyze and record transactions. In very large restaurants, a bookkeeper may handle only one type of transaction, such as sales, accounts receivable collections, or payroll. The accountant then summarizes the bookkeeper's work and further interprets the results for management.

BOOKKEEPING The task of analyzing and recording financial transactions of a specific type (for example, sales, collection of revenue, and payroll).

ACCOUNTING SPECIALTIES

There are several specialized areas within the accounting profession. For example, **financial accounting**—the topic of this book—involves the overall process of developing and using accounting information to make business decisions; the "deliverables" of financial accounting are such financial statements as the balance sheet, income (profit and loss) statement, and the statement of cash flows—all of which are discussed in this book. These are among the most important reports that managers, owners (investors), government agencies, financial institutions, and others use to learn about the financial status of the restaurant.

FINANCIAL ACCOUNTING The process of developing and using accounting information to make business decisions, which involves organizing and presenting financial information in financial statements. The major focus is on the past.

Auditing

Auditing is another accounting specialty. Auditors review the internal controls of restaurants to assess measures taken to safeguard cash and inventory. They study the accounting system to ensure the proper recording and reporting of financial information. Auditors evaluate whether the restaurant's financial statements fairly present the financial position, operating results, and cash inflows and outflows by activity, and whether generally accepted accounting principles are consistently applied from period to period.

AUDITING The accounting specialty that involves studying the restaurant's internal controls and analyzing the basic accounting system to assure that all financial information is properly recorded and reported.

Managerial Accounting

MANAGERIAL ACCOUNTING **The process of using historical and estimated financial information to help managers plan for the future. The major focus is on the future.**

Managerial accounting uses historical and estimated financial information to develop future plans. Managerial accountants may help managers make decisions by assessing the financial impact of alternatives being considered. For example, should the restaurant open or close on a specific day or for a specific meal period? A managerial accountant can study actual and estimated information and provide managers with recommendations.

One way to view the difference between financial accounting and managerial accounting is to focus on the reports they produce. Statements stemming from financial accounting are of particular interest to parties external to the restaurant (investors, creditors, etc.). By contrast, reports stemming from managerial accounting are mainly designed for managers and other internal users. Likewise, they are generated more frequently (weekly or daily) than statements from financial accounting (monthly). Examples of managerial reports are inventory values (separated by product: food and beverage), listings of food and beverage products received, sales history records, and operating reports. Operating reports typically include actual operating results and budget estimates for the period.

Tax Accounting

TAX ACCOUNTING **The accounting specialty that involves planning and preparing for taxes and filing tax-related information with government agencies.**

DEPRECIATION **The allocation of the cost of equipment and other tangible assets as an expense for a series of accounting periods according to the useful life of the assets.**

As the name implies, **tax accounting** is concerned with the tax consequences of business decisions and the preparation of (often) quite complicated tax returns. Accounting methods restaurants use for tax purposes may differ from the methods they use for financial reporting. For example, **depreciation** may be calculated using a method that results in a faster write-off of a piece of equipment for tax purposes than for financial reporting purposes. (This may be preferred because taxable income is lowered, taxes are reduced, and cash is conserved.)

You can see, then, that the accounting field is broad; restaurant managers who must be well versed in diverse areas such as food preparation and service, marketing, personnel management, layout design, and

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equipment and systems maintenance must also be able to organize and use accounting data and procedures to make the best possible management decisions. They may, as well, need to rely on accounting experts as financial systems are designed and as special accounting-related issues arise.[1]

USERS OF ACCOUNTING INFORMATION

We have already emphasized that restaurant managers need accounting information to help evaluate the daily, intermediate (monthly), and long-range success of operations. Other users of accounting information include:

- ***Owners.*** Those who have invested in the business. Owners may include one person in a sole proprietorship, two or more people in a partnership, or up to thousands of people in a corporation. All owners want to know how their investment is doing.
- ***Boards of directors.*** Large restaurants or foodservice chains may have corporate stockholders who elect persons to represent them in the management of the business. They need accounting information to evaluate the effectiveness of the managers who operate their restaurants.
- ***Creditors.*** Those who lend money (lenders) or provide products and/or services (suppliers) want to know the likelihood that payment obligations will be met.

[1]Note: Managers might find it helpful to contact Hospitality Financial & Technology Professionals (HFTP), a professional association for financial and management information systems (MIS) specialists in the hospitality industry. It has over 4,000 members and provides services such as continuing education, seminars, and certification.

- ***Government agencies.*** Income is taxable by the federal government, most states, and many communities. Accounting information is based upon the type of tax assessments that are made. For example, the Internal Revenue Service (at the national level), state revenue departments, and local taxing authorities have an ongoing interest in accounting records. Also, the Securities Exchange Commission (SEC) is required to review audited financial statements as it approves prospective information developed by large restaurant organizations wishing to issue securities to the public.
- ***Employee unions.*** Accounting information is used by union officials and membership in unionized restaurants to assess the abilities of the business to meet wage and benefit demands.
- ***Financial analysts.*** Persons outside of the restaurant, such as staff members of mutual investment and insurance companies, may desire accounting information about a restaurant for their own or their clients' purposes.

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAPs)

GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAPS) Standards that have evolved in the accounting profession to ensure uniformity in the procedures and techniques used to prepare financial statements.

ASSET Something of value that is owned by the restaurant. Examples include cash, product inventories, equipment, land, and building(s).

A set of standards called **Generally Accepted Accounting Principles (GAAPs)** constitutes the framework against which accounting procedures and techniques are measured.

GAAPs include:

1. ***Business entity.*** The restaurant is distinct and separate from its owners; it generates revenues, incurs expenses by using **assets,** and makes a profit, suffers a loss, or "breaks even" by and for itself. The impact of this principle occurs when income is measured as it is generated by the business (there is an increase in owners' equity), not when it is distributed to owners. Likewise, an obligation

owed by the business is considered a **liability.** It may be owed to a vendor to pay for products received, or the liability may be an obligation (such as a loan to the business) which the owners owe to themselves!

LIABILITIES **Obligations (money owed) to outside entities. Examples include amounts owed to suppliers, to lenders for long-term debt such as mortgages, and to employees (payroll that has been earned by but not paid to the restaurant's staff members).**

2. ***Historical cost.*** The value of an asset is its agreed-upon cash equivalent. When a transaction occurs (for example, an asset such as an equipment item is sold), the price paid normally reflects its **current fair value.** Over time, the value 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 accounts and in financial statements.

CURRENT FAIR VALUE **The market value of the asset at the date of the financial statements. For example, assume a building (structure and land) cost $5,000,000. At the time of purchase, the cost would equal the fair value. Two years later the current fair value may be $6,000,000, yet the financial statements would reflect the historical cost of $5,000,000.**

3. ***Going concern.*** An accountant assumes—unless there is reason to believe otherwise—that the restaurant will exist in the indefinite future. If, for example, the restaurant were to cease operation, certain liabilities would be due immediately. Likewise, assets might need to be sold at a considerable loss. When accountants assume that the 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.*** Statements of the restaurant's financial condition, including the income statement, should be developed periodically. For example, income tax regulations require the annual filing of tax returns. Owners and others desire monthly statements about the economic health of their organizations. Tax authorities require annual reports.
5. ***Expenses matched to revenues.*** **Expenses** that are incurred must be matched with, and deducted from, **revenues** that are generated in

EXPENSE **A decrease in a resource (such as food inventory) that occurs when the restaurant sells a product or service.**

REVENUE An increase in a resource (such as cash) when a product or service is sold by the restaurant (often referred to as "sales").

ACCOUNTS RECEIVABLE Money owed to the restaurant, generally from guests, that has not been received.

ACCOUNTS PAYABLE Money owed by the restaurant to suppliers and lenders that has not been paid.

CASH ACCOUNTING SYSTEM An accounting system that treats revenues as income when cash from operating activities is received and expenditures as expenses when cash is paid.

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.

an accrual accounting system that recognizes revenues and expenses without concern about when cash is received or paid by the restaurant. Amounts owed to the restaurant are called **accounts receivable;** amounts owed by the restaurant to suppliers are referred to as **accounts payable.** Small restaurants may use a **cash accounting system** (which treats revenues as income when cash is received and expenditures as expenses when cash is paid). However, GAAPs require an **accrual accounting system,** and this system will be used as the basis for the accounting discussion throughout this book.

6. ***Conservatism.*** This GAAP requires that all losses be shown in financial records if there is a reasonable chance that a problem will occur; gains and related financial benefits, however, should not be reflected in financial records until they are realized. For example, assume a restaurant had a lawsuit for negligence filed against it. If the restaurant's legal advisor indicates that the restaurant is likely to lose and can reasonably estimate the amount, 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 answer." This concept guides the accountant confronted with alternate measurements to select the option that will yield the least favorable impact upon the restaurant's profitability and financial position within the current accounting period.
7. ***Consistency.*** The same procedures used to collect accounting information should be used each fiscal period; if this GAAP were not used, restaurant managers would not have an accurate information base upon which to make decisions.

8. ***Materiality and practicality.*** The significance of financial events impacts the financial viability (long-term operation) of the restaurant. Experience and judgment are necessary to determine whether it is practical to report "minor" financial events and/or matters related to confidential information.

The above and other GAAPs help form the basic foundation upon which accounting systems and procedures must be developed. They provide reasonable requirements but still permit discretion as financial accounting systems are designed for specific restaurants. They help chart the development of accounting systems for restaurants and other businesses. GAAPs taken in concert with three important characteristics of effective accounting systems provide the basic "prerequisites" for useful information:

- Accounting information must be relevant; it must be useful to the specific situation. For example, reports can be produced with greater or less frequency and can be very detailed or less so depending upon the manager's needs. Cost/benefit concerns (whether the information gathered is worth more than the cost to collect it) are of great importance.
- Accounting information must be current; "old" data is generally of little or no assistance as decisions are made in today's fast-paced restaurant operations. Information needed to monitor daily performance must be generated daily. Many managers, for example, develop and analyze food costs and revenues daily; they find the results to be worth the efforts expended to collect the information.
- Accounting data must be accurate. Given the restraints of cost/benefit already discussed (data must be worth more than the costs needed to collect it) the financial information generated must reasonably "tell" (reflect) the financial aspects of the activities measured.

POSITIONS WITH ACCOUNTING RESPONSIBILITIES

Someone must be responsible for developing accounting information for line managers. (According to personnel management principles, **line positions** are

LINE POSITION **A job held by an employee who is in the chain of command; for example, the restaurant manager, department heads such as chef and head bartender, and other decision-makers.**

STAFF POSITION **A job held by a technical specialist such as an accountant, who provides information to but does not make decisions for line personnel.**

held by employees such as managers, department heads, supervisors, and others who are in the chain of command. By contrast, **staff positions,** held by accounting, personnel, and purchasing department employees, provide specialized and advisory assistance to line officials.)

In a small restaurant, the manager (who is likely to be the owner) develops some of the financial information needed for decision-making. However, because of the increasingly complex process needed to generate financial data, especially for tax accounting purposes, the manager/owner of the small restaurant will likely need the services of an external accountant. As restaurants increase in size, some or all of the accounting responsibilities assumed by the manager of the small operation fall to other employees. Here are some examples:

SOURCE DOCUMENT **A record from which financial information is initially drawn and entered into an accounting system.**

- ***Bookkeeper.*** As noted above, bookkeepers are involved in some of the processes by which financial transactions of the restaurant are recorded and summarized. Frequently, bookkeeping services are used by restaurant managers who supply **source documents** (schedule of hours employees worked, delivery invoices, sales data from electronic registers, etc.) to external bookkeepers who develop records, reports, and financial statements for the manager.
- ***Accountant.*** Accountants in large restaurants often work under the controller (see below) and perform duties that include designing and monitoring the data collection system and source documents, summarizing information in financial statements, developing management reports, coordinating budget development, collecting information required by tax authorities, and completing required external reports.
- ***Controller.*** This official is generally the chief accounting officer (CAO) in a large restaurant organization and oversees the development and implementation of the accounting system. The controller may supervise many employees in large firms (if so, accounting-related activities are generally only part of the responsibilities of the position).

- ***Food and beverage controller.*** Moderate- and large-sized restaurants may employ a food and beverage controller who is responsible for developing a wide variety of routine operating and control reports. Likewise, for control purposes, product receiving, storing, and/or issuing activities and responsibilities are frequently assumed by this official. (A basic principle [standard] of control involves the need to separate tasks to make it difficult [at least without collusion] for employees to commit fraudulent acts. If products are purchased by a staff purchasing agent and come under the control of production personnel [chef and bartender] after issuing, the control process is tightened when these intermediate tasks [receiving, storing, and issuing] are the responsibility of the controller.)
- ***Internal auditor.*** Very large restaurants and foodservice chains may employ internal auditors to evaluate the operating effectiveness of the accounting information system. As companies grow into multiunit organizations, corporate-level personnel are often asked to audit records and systems of specific properties.
- ***External accounting positions.*** There are at least two types of external accounting personnel used by restaurants. An accountant (frequently a Certified Public Accountant—CPA) performs services for a fee as an independent agent rather than as an employee. In this role, he/she may develop and monitor accounting systems and procedures used by the restaurant. External auditors can be used to render an opinion as to whether financial statements reflect fairly the financial position of the restaurant and whether the statements are prepared in accordance with generally accepted accounting principles (GAAPs) and on a consistent basis with the prior year.

ACCOUNTING AND CONTROL ARE INTERRELATED

The relationship between the management task of control and accounting activities is important. To control any resource (food and beverage products, labor, revenue, energy, etc.), the restaurant manager must use a five-step process:

1. Performance standards (expectations) must be established. (This is done as the operating budget is developed.)

2. Actual financial information must be collected to measure the results of operation.
3. Comparisons must be made between expected performance (Step 1) and actual performance (Step 2).
4. Corrective action must be taken when necessary to bring actual results (Step 2) in line with expected performance (Step 1). Generally, an investigation of alternative causes of problems (negative variances) and their assumed impact on standards is required.
5. Evaluation of the results of the corrective action procedures is necessary.

Collecting actual information (Step 2 above) is done through the formal process of accounting. This provides a clear example of the relationship between financial accounting (with its emphasis on external communication) and managerial accounting (which focuses upon internal management communication).

Generally, the restaurant's accounting system yields information useful for both external and internal purposes. As data is collected for one purpose (financial statements) it can also be used for another (for example, operating reports used by managers). Suppose the manager establishes a budgeted food cost percentage. (If all goes well, a specified percentage of revenue generated from food sales will be used to purchase the food required to generate more food revenue.) Actual operating results (the assessment of dollars actually spent to purchase food) will be measured through the use of an accrual accounting system. (This will require calculating cost of goods sold: Changes between beginning and ending inventory values along with the cost of purchases during the fiscal period and various adjustments that consider employee and promotional meals and transfers between the food and beverage departments will likely be made.) The difference between the budgeted food cost and actual food cost suggests the extent to which operating procedures may need to be revised. Note that actual food costs developed through the formal accounting system could be used both for information on the financial statement and for routine operating control.

RELATIONSHIP BETWEEN MANAGER AND ACCOUNTANT

The most effective relationship between the manager and the accountant has already been noted; the accountant serves in a staff (advisory) relationship to the manager and provides specialized help to the manager as needed. Sometimes, however, managers are much more passive, because they are unfamiliar with either accounting principles and/or the development/use of accounting systems. These passive managers believe their role in the financial management of the restaurant is to:

- "Do what the accountant says" and provide and accept information using systems and procedures suggested by the accountant.
- Believe that accounting information, regardless of how it is collected, analyzed, or reported, is correct. (In fact, the failure to consider the accuracy of accounting information can be a significant impediment to problem-solving.)
- Use accounting information regardless of how it is presented in formal financial statements. Many managers make decisions with information from various reports and statements that they neither helped to design nor understand. When this occurs, managers often make misinformed decisions.
- Defer to the accountant all or much of the responsibility for making decisions about financial matters. This practice violates the basic distinction between line and staff relationships.
- View the accountant as a "necessary evil" rather than as a partner and helpful provider of useful information.

Each of the above perceptions frequently arises when the role of the accountant in the restaurant operation is not properly understood. In practice, remember that the manager should be the expert who makes decisions. While managers need financial information provided by the accountant, they must determine the meaning of the data themselves. Therefore, a more proper relationship between the manager and the accountant should include the following essentials:

- The manager must know, at minimum, the information required for short- and long-term control of the restaurant's operation. Once the manager has identified what information he or she needs, the accountant can offer advice about the best ways to gather that information.
- Information needed for internal control purposes should be combined with that used to assemble required financial statements. In this way, there is a "dovetailing" effect; the need to keep two sets of books is minimized.

- After receiving input from the manager, the accountant should design an information collection system that assembles information required for both management and accounting purposes.
- After information is developed into financial statements, the accountant can assist the manager in analysis and make corrective action recommendations, if necessary.
- Wise restaurant managers carefully consider the advice of the accountant. They recognize, however, that it is their responsibility, not the accountant's, to make operating decisions.
- The manager should ask questions when fiscal information supplied by the accountant is analyzed. For example, he or she might ask: "How were values of revenues and expenses derived?" "What do the figures mean?" "What are the consistencies and inconsistencies in the way information was collected between fiscal periods?"

The overriding point here is that the manager should be in charge of the restaurant. This means assembling all available talent including that of the accountant to make the best management decisions. Ultimately, the manager—not the accountant—must make decisions. The relationship between the manager and accountant is, then, a team effort. The manager makes use of accounting-related resources to maximize attainment of the restaurant's goals.

MANAGER'S 10 POINT EFFECTIVENESS CHECKLIST

Evaluate your need for and the status of each of the following financial management tactics. For tactics you judge to be important but not yet in place, develop an action plan including completion date to implement the tactic.

TACTIC	DON'T AGREE (DON'T NEED)	AGREE (DONE)	AGREE (NOT DONE)	IF NOT DONE	
				WHO IS RESPONSIBLE?	TARGET COMPLETION DATE
1. Manager has purchased an up-to-date hospitality financial management resource to use as a management aid.	❑	❑	❑		
2. Management thoroughly understands the difference between bookkeeping and accounting.	❑	❑	❑		
3. Manager knows all individuals and organizations that will use the financial information produced by the restaurant's management team.	❑	❑	❑		
4. Manager has an effective system in place for administering accounts receivable.	❑	❑	❑		
5. Manager has an effective system in place for administering accounts payable.	❑	❑	❑		
6. Manager recognizes the importance of protecting the integrity of source documents and has systems in place to do so.	❑	❑	❑		
7. Manager understands the difference between line and staff assistance in financial management of the restaurant.	❑	❑	❑		
8. Manager clearly understands the difference between financial management and accounting.	❑	❑	❑		
9. The restaurant's financial management system incorporates Generally Accepted Accounting Principles (GAAPs).	❑	❑	❑		
10. Manager has established a schedule of regular meetings with the restaurant accountant.	❑	❑	❑		