Restaurant Financial Basics

BIBLIOTEX
Digital Library

RESTAURANT FINANCIAL BASICS

BIBLIOTEX
Digital Library
www.bibliotex.com

RESTAURANT FINANCIAL BASICS

BIBLIOTEX
Digital Library

www.bibliotex.com
email: info@bibliotex.com

e-book Edition 2022
ISBN: 978-1-98467-653-5 (e-book)

In Collaboration with 3G E-Learning LLC. Originally Published in printed book format by 3G E-Learning LLC with ISBN 978-1-98465-946-0

EDITORIAL BOARD

Aleksandar Mratinković was born on May 5, 1988 in Arandjelovac, Serbia. He has graduated on Economic high school (2007), The College of Tourism in Belgrade (2013), and also has a master degree of Psychology (Faculty of Philosophy, University of Novi Sad). He has been engaged in different fields of psychology (Developmental Psychology, Clinical Psychology, Educational Psychology and Industrial Psychology) and has published several scientific works.

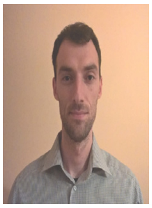
Dan Piestun (PhD) is currently a startup entrepreneur in Israel working on the interface of Agriculture and Biomedical Sciences and was formerly president-CEO of the National Institute of Agricultural Research (INIA) in Uruguay. Dan is a widely published scientist who has received many honours during his career including being a two-time recipient of the Amit Golda Meir Prize from the Hebrew University of Jerusalem, his areas of expertise includes stem cell molecular biology, plant and animal genetics and bioinformatics. Dan's passion for applied science and technological solutions did not stop him from pursuing a deep connection to the farmer, his family and nature. Among some of his interest and practices counts enjoying working as a beekeeper and onboard fishing.

Hazem Shawky Fouda has a PhD. in Agriculture Sciences, obtained his PhD. From the Faculty of Agriculture, Alexandria University in 2008. He is working in Cotton Arbitration & Testing General Organization (CATGO).

Felecia Killings is the Founder and CEO of LiyahAmore Publishing, a publishing company committed to providing technical and educational services and products to Christian Authors. She operates as the Senior Editor and Writer, the Senior Writing Coach, the Content Marketing Specialist, Editor-in-Chief to the company's quarterly magazine, the Executive and Host of an international virtual network, and the Executive Director of the company's online school for Authors. She is a former high-school English instructor and professional development professor. She possesses a Master of Arts degree in Education and a Bachelor's degree in English and African American studies.

Dr. Sandra El Hajj, Ph.D. in Health Sciences from Nova Southeastern University, Florida, USA is a health professional specialized in Preventive and Global Health. With her 12 years of education obtained from one of the most prominent universities in Beirut, in addition to two leading universities in the State of Florida (USA), Dr. Sandra made sure to incorporate interdisciplinary and multicultural approaches in her work. Her long years of studies helped her create her own miniature world of knowledge linking together the healthcare field with Medical Research, Statistics, Food Technology, Environmental & Occupational Health, Preventive Health and most noteworthy her precious last degree of Global Health. Till today, she is the first and only doctor specialized in Global Health in the Middle East area.

Fozia Parveen has a Dphil in Sustainable Water Engineering from the University of Oxford. Prior to this she has received MS in Environmental Sciences from National University of Science and Technology (NUST), Islamabad Pakistan and BS in Environmental Sciences from Fatima Jinnah Women University (FJWU), Rawalpindi.



Igor Krunic 2003-2007 in the School of Economics. After graduating in 2007, he went on to study at The College of Tourism, at the University of Belgrade where he got his bachelor degree in 2010. He was active as a third-year student representative in the student parliament.Then he went on the Faculty of science, at the University of Novi Sad where he successfully defended his master's thesis in 2013. The crown of his study was the work titled Opportunities for development of cultural tourism in Cacak". Later on, he became part of a multinational company where he got promoted to a deputy director of logistic. Nowadays he is a consultant and writer of academic subjects in the field of tourism.

Dr. Jovan Pehcevski obtained his PhD in Computer Science from RMIT University in Melbourne, Australia in 2007. His research interests include big data, business intelligence and predictive analytics, data and information science, information retrieval, XML, web services and service-oriented architectures, and relational and NoSQL database systems. He has published over 30 journal and conference papers and he also serves as a journal and conference reviewer. He is currently working as a Dean and Associate Professor at European University in Skopje, Macedonia.

Dr. Tanjina Nur finished her PhD in Civil and Environmental Engineering in 2014 from University of Technology Sydney (UTS). Now she is working as Post-Doctoral Researcher in the Centre for Technology in Water and Wastewater (CTWW) and published about eight International journal papers with 80 citations. Her research interest is wastewater treatment technology using adsorption process.

Stephen obtained his PhD from the University of North Carolina at Charlotte in 2013 where his graduate research focused on cancer immunology and the tumor microenvironment. He received postdoctoral training in regenerative and translational medicine, specifically gastrointestinal tissue engineering, at the Wake Forest Institute of Regenerative Medicine. Currently, Stephen is an instructor for anatomy and physiology and biology at Forsyth Technical Community College.

Michelle holds a Masters of Business Administration from the University of Phoenix, with a concentration in Human Resources Management. She is a professional author and has had numerous articles published in the Henry County Times and has written and revised several employee handbooks for various YMCA organizations throughout the United States.

HOW TO USE THE BOOK

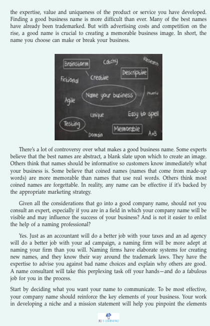
This book has been divided into many chapters. Chapter gives the motivation for this book and the use of templates. The text is presented in the simplest language. Each paragraph has been arranged under a suitable heading for easy retention of concept. Keywords are the words that academics use to reveal the internal structure of an author's reasoning. Review questions at the end of each chapter ask students to review or explain the concepts. References provides the reader an additional source through which he/she can obtain more information regarding the topic.

LEARNING OBJECTIVES

See what you are going to cover and what you should already know at the start of each chapter

ABOUT THIS CHAPTER

An introduction is a beginning of section which states the purpose and goals of the topics which are discussed in the chapter. It also starts the topics in brief.

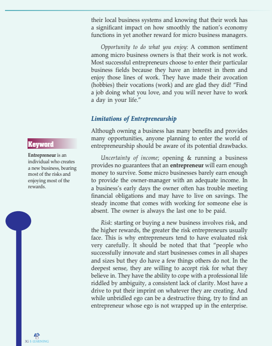


REMEMBER

This revitalizes a must read information of the topic.

KEYWORDS

This section contains some important definitions that are discussed in the chapter. A keyword is an index entry that identifies a specific record or document. It also gives the extra information to the reader and an easy way to remember the word definition.



DID YOU KNOW?

This section equip readers the interesting facts and figures of the topic.

EXAMPLE

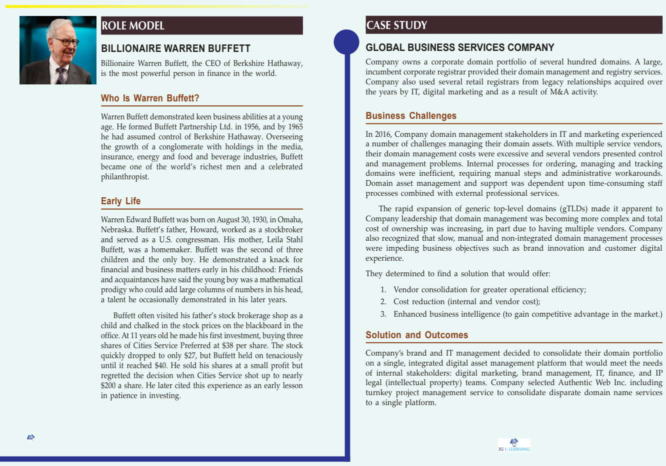
The book cabinets' examples to illustrate specific ideas in each chapter.

ROLE MODEL

A biography of someone who has/had acquired remarkable success in their respective field as Role Models are important because they give us the ability to imagine our future selves.

CASE STUDY

This reveals what students need to create and provide an opportunity for the development of key skills such as communication, group working and problem solving.



MULTIPLE CHOICE QUESTIONS

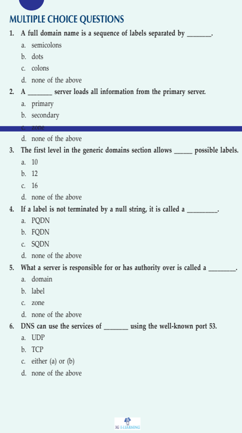
This is given to the students for progress check at the end of each chapter.

REVIEW QUESTIONS

This section is to analyze the knowledge and ability of the reader.

REFERENCES

References refer those books which discuss the topics given in the chapters in almost same manner.



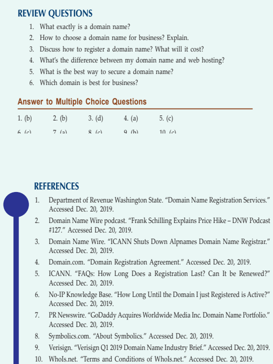


TABLE OF CONTENTS


CASH FLOW

Chapter 6 Pricing for Profits 231

Chapter 7 Accounting Aspects of Food and Beverage Control 271

PREFACE

One of the most effective tools any restaurant has is the ability to track food and beverage sales on a daily basis. A daily business review can help analyze sales trends, payroll costs, customer counts, and predict future sales. More than half the restaurants that open fail in their first two years of service. This is a known fact in the restaurant industry and one of the main reasons the industry is so feared by new entrepreneurs. While it is true that the restaurant space is ruthless, there are still those who open up and not just survive the business but also lead the industry. What enables them to do it? While multiple factors contribute to the success of a restaurant, managing the restaurant finances the right way is a significant reason behind it. Most restaurants lack an excellent financial management system. Usually, first-time restaurateurs are so focused on arranging the capital for opening a restaurant that they forget about the working capital, that is, the money that would sustain the business, until the restaurant reaches its break-even and starts generating profit

Organization of the Book

This book is designed to provide a basic overview of the operation of a restaurant from a financial perspective. The book presents understanding of the basics of financial management for food service, how restaurants create budgets, manage expenses, pay employees and more.

Chapter 1 presents an introduction to financial management. 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.

Chapter 2 shows the mechanics of accounting. It explains the types of business transactions and the types of accounts. Moreover, it discusses the accounting cycle and specialized journals.

Chapter 3 focuses on balance sheet. A restaurant balance sheet lists out a restaurant's assets, liabilities, and equity at a given point in time. This statement can be used to forecast short and long-term cash flow and assess the overall financial health of the restaurant.

Chapter 4 illustrates the income statement for a restaurant. An income statement is one of the three important financial statements used for reporting a company's financial performance over a specific accounting period, with the other two key statements being the balance sheet and the statement of cash flows.

Chapter 5 discusses the basic concept of cash flow and explain the statement of cash flows. Moreover, it sheds light on funds flow statement.

Chapter 6 focuses on pricing for profits. The restaurant industry is not for the faint of heart. While passion is the spark that inspires restaurateurs to pursue their dreams, profit margins determine whether or not those dreams are a sustainable business. Unfortunately, profit margins are dwindling across the restaurant industry.

Chapter 7 describes the accounting aspects of food and beverage control. The effective manager has to manage and control all the various operating expenses in a foodservice operation. In the end, the goal is typically to make a profit. Food and beverage expenses combined are one of the largest expense categories for foodservice operations.

CHAPTER 1

INTRODUCTION TO FINANCIAL MANAGEMENT

"Financial prosperity is impossible without constant planning and management of money."

- Sunday Adelaja

INTRODUCTION

Financial management may be defined as the area or function in an organization which is concerned with profitability, expenses, cash and credit, so that the "organization may have the means to carry out its objective as satisfactorily as possible;" the latter often defined as maximizing the value of the firm for stockholders. Financial managers (FM) are specialized professionals directly reporting to senior management, often the financial director (FD); the function is seen as 'Staff', and not 'Line'.

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

1. Define the financial management
2. Learn about accounting specialties
3. Learn about users of accounting information
4. Understand the generally accepted accounting principles (GAAPs)
5. Discuss about positions with accounting responsibilities
6. Explain the accounting and control are interrelated
7. Describe the relationship between manager 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-yetopened), 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.

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.

1.1 FINANCIAL MANAGEMENT

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.

1.1.1 Meaning of Finance

Keyword

Bookkeeping is the process of keeping track of every financial transaction made by a business firm from the opening of the firm to the closing of the firm.

Finance may be defined as the art and science of managing money. It includes financial service and financial instruments. Finance also is referred as the provision of money at the time when it is needed. Finance function is the procurement of funds and their effective utilization in business concerns.

The concept of finance includes capital, funds, money, and amount. But each word is having unique meaning. Studying and understanding the concept of finance become an important part of the business concern.

According to the researcher, “Finance is the art and science of managing money”. Or the word ‘finance’ connotes ‘management of money’.

Another defines finance as “the Science on study of the management of funds’ and the management of fund as the system that includes the circulation of money, the granting of credit, the making of investments, and the provision of banking facilities.

1.1.2 Types of Finance

Finance is one of the important and integral part of business concerns, hence, it plays a major role in every part of the business activities. It is used in all the area of the activities under the different names. (See Figure 1)

Finance can be classified into two major parts:

- ***Private finance***, which includes the individual, firms, business or corporate financial activities to meet the requirements.
- ***Public finance*** which concerns with revenue and disbursement of government such as Central Government, State Government and Semi-Government Financial matters.

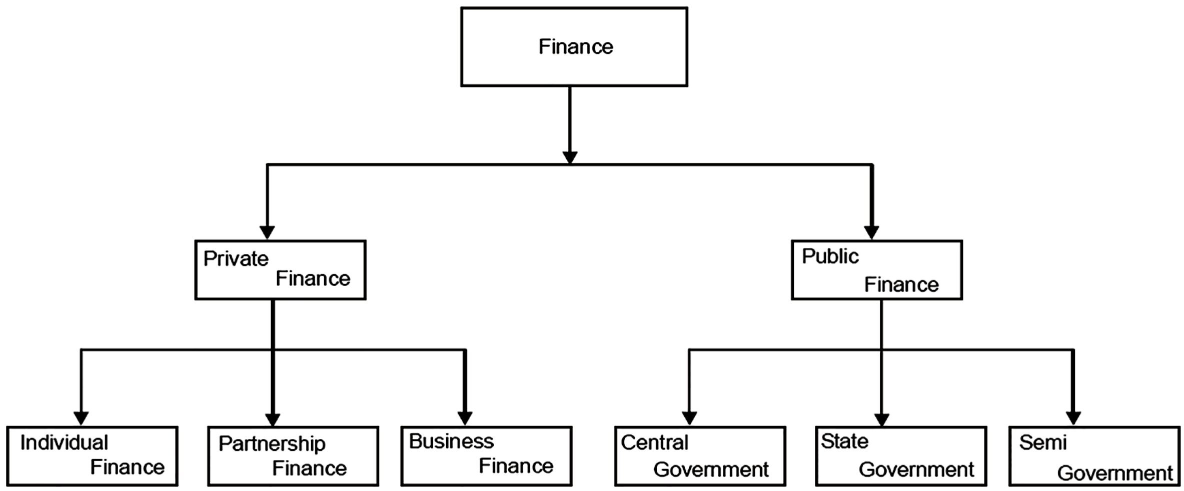


Figure 1. Types of finance.

1.1.3 Definition of Financial Management

Financial management is an integral part of overall management. It is concerned with the duties of the financial managers in the business firm.

The term financial management has been defined by researcher, "It is concerned with the efficient use of an important economic resource namely, capital funds".

The most popular and acceptable definition of financial management as "Financial Management deals with procurement of funds and their effective utilization in the business."

Financial management as an application of general managerial principles to the area of financial decision-making.

DID YOU KNOW ?

The Financial Management Service is one of Treasury's newer major bureaus, having been established as the Bureau of Government Financial Operations in 1974.

Another definition financial management "is an area of financial decision-making, harmonizing individual motives and enterprise goals".

Thus, Financial Management is mainly concerned with the effective funds management in the business. In simple words, Financial Management as practiced by business firms can be called as Corporation Finance or Business Finance.

1.1.4 Scope of Financial Management

Financial management is one of the important parts of overall management, which is directly related with various functional departments like personnel, marketing and production.

Financial management covers wide area with multidimensional approaches. The following are the important scope of financial management.

- ***Financial Management and Economics:*** Economic concepts like micro and macroeconomics are directly applied with the financial management approaches. Investment decisions, micro and macro environmental factors are closely associated with the functions of financial manager. Financial management also uses the economic equations like money value discount factor, economic order quantity etc. Financial economics is one of the emerging area, which provides immense opportunities to finance, and economical areas.

- ***Financial Management and Accounting:*** Accounting records includes the financial information of the business concern. Hence, we can easily understand the relationship between the financial management and accounting. In the olden periods, both financial management and accounting are treated as a same discipline and then it has been merged as Management Accounting because this part is very much helpful to finance manager to take decisions. But now a day's financial management and accounting discipline are separate and interrelated.
- ***Financial Management or Mathematics:*** Modern approaches of the financial management applied large number of mathematical and statistical tools and techniques. They are also called as econometrics. Economic order quantity, discount factor, time value of money, present value of money, cost of capital, capital structure theories, dividend theories, ratio analysis and working capital analysis are used as mathematical and statistical tools and techniques in the field of financial management.
- ***Financial Management and Production Management:*** Production management is the operational part of the business concern, which helps to multiple the money into profit. Profit of the concern depends upon the production performance. Production performance needs finance, because production department requires raw material, machinery, wages, operating expenses etc. These expenditures are decided and estimated by the financial department and the finance manager allocates the appropriate finance to production department. The financial manager must be aware of the operational process and finance required for each process of production activities.
- ***Financial Management and Marketing:*** Produced goods are sold in the market with innovative and modern approaches. For this, the marketing department needs finance to meet their requirements. The financial manager or finance department is responsible to allocate the adequate finance to the marketing department. Hence, marketing and financial management are interrelated and depends on each other.
- ***Financial Management and Human Resource:*** Financial management is also related with human resource department, which provides manpower to all the functional areas of the management. Financial manager should carefully evaluate the requirement of manpower to each department and allocate the finance to the human resource department as wages, salary, remuneration, commission, bonus, pension and other monetary benefits to the human resource department. Hence, financial management is directly related with human resource management.

1.1.5 Importance of Financial Management

Finance is the lifeblood of business organization. It needs to meet the requirement of the business concern. Each and every business concern must maintain adequate amount of finance for their smooth running of the business concern and also maintain the business carefully to achieve the goal of the business concern. The business goal can be achieved only with the help of effective management of finance. We cannot neglect the importance of finance at any time at and at any situation. Some of the importance of the financial management is as follows:

- ***Financial Planning:*** Financial management helps to determine the financial requirement of the business concern and leads to take financial planning of the concern. Financial planning is an important part of the business concern, which helps to promotion of an enterprise.
- ***Acquisition of Funds:*** Financial management involves the acquisition of required finance to the business concern. Acquiring needed funds play a major part of the financial management, which involve possible source of finance at minimum cost.
- ***Proper Use of Funds:*** Proper use and allocation of funds leads to improve the operational efficiency of the business concern. When the finance manager uses the funds properly, they can reduce the cost of capital and increase the value of the firm.
- ***Financial Decision:*** Financial management helps to take sound financial decision in the business concern. Financial decision will affect the entire business operation of the concern. Because there is a direct relationship with various department functions such as marketing, production personnel, etc.
- ***Improve Profitability:*** Profitability of the concern purely depends on the effectiveness and proper utilization of funds by the business concern. Financial management helps to improve the profitability position of the concern with the help of strong financial control devices such as budgetary control, ratio analysis and cost volume profit analysis.
- ***Increase the Value of the Firm:*** Financial management is very important in the field of increasing the wealth of the investors and the business concern. Ultimate aim of any business concern will achieve the maximum profit and higher profitability leads to maximize the wealth of the investors as well as the nation.

- ***Promoting Savings:*** Savings are possible only when the business concern earns higher profitability and maximizing wealth. Effective financial management helps to promoting and mobilizing individual and corporate savings.

Nowadays financial management is also popularly known as business finance or corporate finances. The business concern or corporate sectors cannot function without the importance of the financial management.

1.1.6 Inter-relation among Financial Decisions

All the major functions or decisions – Investment function, Finance function, Liquidity function and Dividend function, are inter-related and inter-connected. They are inter-related because the goal of all the functions is one and the same. Their ultimate objective is only one – achievement of maximization of shareholders' wealth or maximizing the market value of the shares.

All the decisions are also inter-connected or inter-dependent also. Let us illustrate both these aspects with an example.

Example: If a firm wants to undertake a project requiring funds, this investment decision cannot be taken, in isolation, without considering the availability of finances, which is a finance decision. Both the decisions are inter-connected.

If the firm allocates more funds for fixed assets, lesser amount would be available for current assets. So, financing decision and liquidity decision are inter-connected.

The firm has two options to finance the project, either from internal resources or raising funds, externally, from the market. If the firm decides to meet the total project cost only from internal resources, the profits, otherwise available for distribution in the form of dividend, have to be retained to meet the project cost. Here, the finance decision has influenced the dividend decision.

So, an efficient financial management takes the optimal decision by considering the implications or impact of all the decisions, together, on the market value of the company's shares. The decision has to be taken considering all the angles, simultaneously.

No Function is Superior

All the functions are important. Importance of the function depends on the situation of the firm. If a firm has adequate investment opportunities but experiences difficulty to raise funds, then the finance function is superior to the firm, at that juncture. It does not mean that investment decision is less important compared to finance decision, always.

The essence is no financial function or decision is superior to others. (See Figure 2)

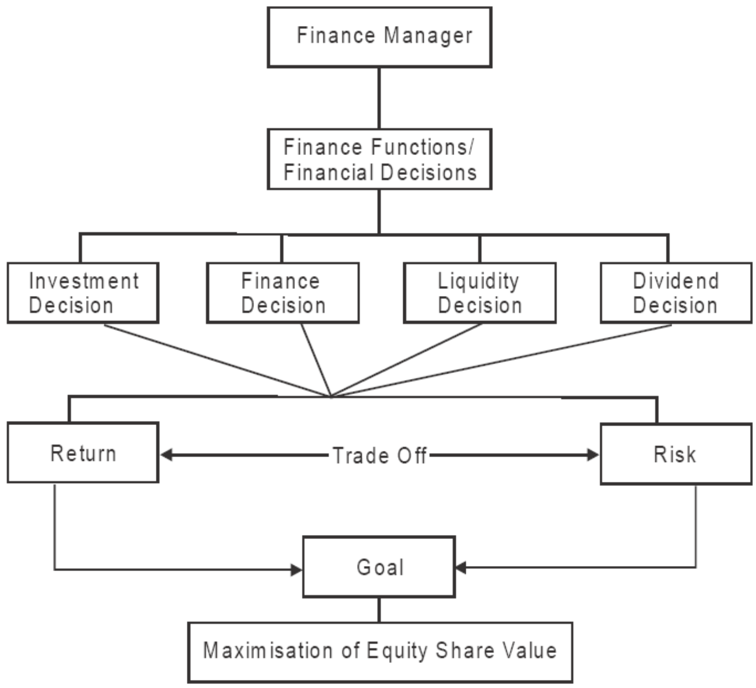


Figure 2. Goal of financial management.

1.1.7 Nature of Financial Management

The nature of financial management is the relationship with economics and accounting, its functions and its scope. Financial management is the way and the means of making money, the application of the functions of planning and control to the finance function.

The modern approach to financial management is to find out how much money is required by the company in question, and then to source at least that amount. The amount should then be invested to ensure that the objectives of the financial management and the company as a whole are met. To break this down into simple terms, financial management have the responsibility to estimate the funds required, raise the funds and finally to invest the funds.

When raising finance a financial management team should ensure that they strike a balance of owned and borrowed funds. This is simply so the company does not have too big an amount of debt on its hands. Once the funds have been raised it is important to spend them wisely, normally on fixed assets and using the balance as working capital. Fixed assets should only be purchased if they can add value to the business, especially long-term value. Most fixed assets that would be purchased by a company will be expensive so they need to be able to produce work for a considerable period of time.

Working capital will be required for the day-to-day running of the company, and for emergencies. This working capital should not be too large as spare money may gain interest in the bank but it should be cycled back into the company.

An important decision of financial management is how much to pay the shareholders, and how much to retain as working capital for the business. Shareholders expectations and the company performance as whole need to be taken into consideration when making this decision.

1.1.8 Functional Areas of Modern Financial Management

Financial management, at present is not confined to raising and allocating funds. The study of financial institutions like stock exchange, capital, market, etc. is also emphasized because they influenced under writing of securities and corporate promotion. Company finance was considered to be the major domain of financial management. The scope of this subject has widened to cover capital structure, dividend policies, profit planning and control, depreciation policies. Some of the functional areas covered in financial management as:

- ***Determining Financial Needs:*** A finance manager is supposed to meet financial needs of the enterprise. For this purpose, he should determine financial needs of the concern. Funds are needed to meet promotional expenses, fixed and working capital needs. The requirement of fixed assets is related to types of industry. A manufacturing concern will require more investments in fixed assets than a trading concern. The working capital needs depend upon scale of operations. Larger the scale of operations, the higher will be the needs for working capital. A wrong assessment of financial needs may jeopardize the survival of a concern.
- ***Choosing the Sources of Funds:*** A number of sources may be available for raising funds. A concern may be resort to issue of share capital and debentures. Financial institutions may be requested to provide long-term funds. The working capital needs may be met by getting cash credit or overdraft facilities from commercial bands. A finance manager has to be very careful and cautions in approaching different sources.
- ***Financial Analysis and Interpretation:*** The analysis and interpretation of financial statements is an important task of a finance manager. He is expected

to know about the profitability, liquidity position, short term and long-term financial position of the concern. For this purpose, a number of ratios have to be calculated. The interpretation of various ratios is also essential to reach certain conclusions financial analysis and interpretation has become an important area of financial management.

- ***Cost-Volume Profit Analysis:*** This is popularly known as "CVP relationship". For this purpose, fixed costs, variable costs and semi variable costs have to be analyzed. Fixed costs are more or less constant for varying sales volumes. Variable costs vary according to the sales volume. Semi-variable costs are either fixed or variable in the short-term. The financial manager has to ensure that the income of the firm will cover its variable costs, for there is no point in being in business, if this is not accomplished. Moreover, a firm will have to generate an adequate income to cover its fixed costs as well. The financial manager has to find out the break-even point that is, the point at which the total costs are matched by total sales or total revenue.

Keyword

Capital budgeting is the process of making investment decisions in capital expenditures.

- ***Working Capital Management:*** Working capital refers to that part of firm's capital which is required for financing short-term or current assets such as cash, receivables and inventories. It is essential to maintain proper level of these assets. Finance manager is required to determine the quantum of such assets.
- ***Dividend Policy:*** Dividend is the reward of the shareholders for investments made by them in the shares of the company. The investors are interested in earning the maximum return on their investments whereas management wants to retain profits for future financing. These contradictory aims will have to be reconciled in the interests of shareholders and the company. Dividend policy is an important area of financial management because the interest of the shareholders and the needs of the company are directly related to it.
- ***Capital Budgeting:*** Capital budgeting is the process of making investment decisions in capital expenditures.

It is an expenditure the benefits of which are expected to be received over a period of time exceeding one year. It is expenditure for acquiring or improving the fixed assets, the benefits of which are expected to be received over a number of years in future. **Capital budgeting** decisions are vital to any organization. Any unsound investment decision may prove to be fatal for the very existence of the concern.

1.1.9 Organization of the Finance Functions

Finance functions can be divided into three major decisions, which the firm must make, namely the investment decision, the finance decision, and the dividend decision.

Each of these decisions must be considered in relation to the objective of the firm: an optimal combination of the three decisions will maximize the value of the share to its shareholders. Since, these decisions are interrelated; we must consider their joint impact on the market price of the firm's stock.

Keyword

Liquidity decision is concerned with the management of the current assets, which is a pre-requisite to long-term success of any business firm.

Investment Decision

The investment decision is the most important one among the three decisions. It relates to the selection of assets in which funds are invested by the firm. The assets, which can be acquired, fall into two broad groups:

- Long-term assets which will yield a return over a period of time in future.
- Short-term current assets which are convertible into cash in the normal course of business usually within a year.

Accordingly, the asset selection decision of a firm is of two types. The first of these involving the first category of assets is popularly known as capital budgeting. The other one, which refers to short-term assets, is designated as **liquidity decision**.

Capital Budgeting Decision

It is the most crucial financial decision of a firm which relates to the selection of an investment proposal whose benefits are likely to arise in future over the life-time of the project. The first aspect of the capital budgeting decision is the choice of the investment out of the available alternatives. The selection will be always based on the relative benefits and returns associated with it. Therefore, the measurement of the worth of the investment proposal is a major element in the capital budgeting decision. Another aspect of the capital budgeting decision is the analysis of risk and uncertainty. As, the benefits from the proposed investment relate to the future period, their accrual is uncertain. Thus, an element of risk in the sense of uncertainty of future benefits is involved. Investment should be evaluated in relation to the risk associated with it. Finally, this return should be judged with a certain norm, which is referred by several names such as cut-off rate, required rate, hurdle rate, minimum rate of return, etc.

The correct standard to use for this purpose is the company's cost of capital, which is another important aspect of the capital budgeting decision.

Liquidity Decision

The liquidity decision is concerned with the management of the current assets, which is a pre-requisite to long-term success of any business firm. The main objective of the current assets: management is the trade - off between profitability and liquidity.

There is a conflict between these two concepts. If a firm does not have adequate working capital, it may become illiquid and consequently fail to meet its current obligations thus inviting the risk of bankruptcy. On the contrary, if the current assets are too large, the profitability is adversely affected. Hence, the key strategy and the main consideration in ensuring a trade-off between profitability and liquidity is the major objective of the liquidity decision. Besides, the funds should be invested optimally in the individual current assets to avoid inadequacy or excessive locking up of funds in these assets. Thus, the liquidity decision should obtain the basic two ingredients, i.e. overview of working capital management and the efficient allocation of funds on the individual current assets.

Financing Decision

The second major decision of the firm is the financing decision for determining the best financing mix of the firm. After determining the asset-mix, the financial manager must decide the mode of raising the funds to meet the firm's investment requirements.

The major issue in decision is to determine the proportion of equity and debt capital. Since the involvement of debt capital affects the return and risk of shareholders, the financial manager should get the optimal capital structure to maximize the shareholders' return with financial management: minimum risk, in other words the cost of capital is the lowest and the market value of An Introduction the share is the highest at that combination of debt and equity. Thus, the financing decision covers two inter-related aspects:

- Capital structure theory
- Capital structure decision

Dividend Decision

The third important decision of a firm is its dividend policy. The financial manager must decide whether the firm should distribute all profits or retain it in the firm or distribute part and retain the balance. The dividend decision should be taken in terms of its impact on the shareholders' wealth. The optimum dividend policy is one, which maximizes the market value of share. Thus, if the shareholders are not indifferent to the firm's dividend policy, the financial manager must determine the optimum dividend-payout ratio. Another important aspect of the dividend decision is the factors determining dividend policy of the firm in practice.

The financial management involves the solution of the three decisions of the firm according to the modern approach. The traditional approach with a very narrow perception was devoid of an integrated conceptual and analytical framework.

In contrast the modern approach has broadened the scope of financial management to ensure the optimum decisions by fulfilling the objectives of the business firm.

1.1.10 Objectives of Financial Management

Effective procurement and efficient use of finance lead to proper utilization of the finance by the business concern. It is the essential part of the financial manager. Hence, the financial manager must determine the basic objectives of the financial management. Objectives of financial management may be broadly divided into two parts such as: (See Figure 3)

- Profit maximization
- Wealth maximization

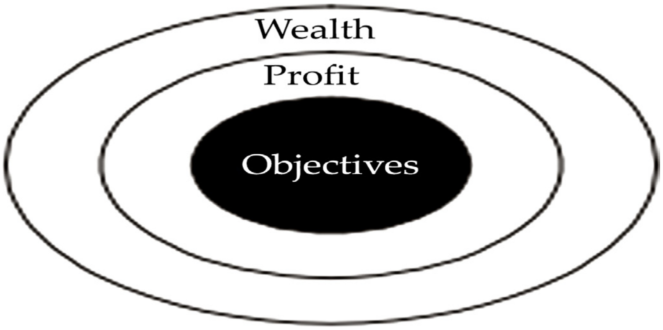


Figure 3. Objectives of financial management.

Profit Maximization

Main aim of any kind of economic activity is earning profit. A business concern is also functioning mainly for the purpose of earning profit. Profit is the measuring techniques to understand the business efficiency of the concern. Profit maximization is also the traditional and narrow approach, which aims at, maximizes the profit of the concern. Profit maximization consists of the following important features.

- Profit maximization is also called as cashing per share maximization. It leads to maximize the business operation for profit maximization.
- Ultimate aim of the business concern is earning profit; hence, it considers all the possible ways to increase the profitability of the concern.
- Profit is the parameter of measuring the efficiency of the business concern. So it shows the entire position of the business concern.
- Profit maximization objectives help to reduce the risk of the business.

Favorable Arguments for Profit Maximization

The following important points are in support of the profit maximization objectives of the business concern:

- Main aim is earning profit.
- Profit is the parameter of the business operation.
- Profit reduces risk of the business concern.
- Profit is the main source of finance.
- Profitability meets the social needs also.

Unfavorable Arguments for Profit Maximization

The following important points are against the objectives of profit maximization:

- Profit maximization leads to exploiting workers and consumers.
- Profit maximization creates immoral practices such as corrupt practice, unfair trade practice, etc.
- Profit maximization objectives leads to inequalities among the stake holders such as customers, suppliers, public shareholders, etc.

Drawbacks of Profit Maximization

Profit maximization objective consists of certain drawback also:

- *It is vague:* In this objective, profit is not defined precisely or correctly. It creates some unnecessary opinion regarding earning habits of the business concern.
- *It ignores the time value of money:* Profit maximization does not consider the time value of money or the net present value of the cash inflow. It leads certain differences between the actual cash inflow and net present cash flow during a particular period.
- *It ignores risk:* Profit maximization does not consider risk of the business concern. Risks may be internal or external which will affect the overall operation of the business concern.

Wealth Maximization

Wealth maximization is one of the modern approaches, which involves latest innovations and improvements in the field of the business concern. The term wealth means shareholder wealth or the wealth of the persons those who are involved in the business concern.

Wealth maximization is also known as value maximization or net present worth maximization. This objective is a universally accepted concept in the field of business.

Favorable Arguments for Wealth Maximization

- Wealth maximization is superior to the profit maximization because the main aim of the business concern under this concept is to improve the value or wealth of the shareholders.
- Wealth maximization considers the comparison of the value to cost associated with the business concern. Total value detected from the total cost incurred for the business operation. It provides extract value of the business concern.

- Wealth maximization considers both time and risk of the business concern.
- Wealth maximization provides efficient allocation of resources.
- It ensures the economic interest of the society.

Unfavorable Arguments for Wealth Maximization

- Wealth maximization leads to prescriptive idea of the business concern but it may not be suitable to present day business activities.
- Wealth maximization is nothing, it is also profit maximization, it is the indirect name of the profit maximization.
- Wealth maximization creates ownership-management controversy.
- Management alone enjoys certain benefits.
- The ultimate aim of the wealth maximization objectives is to maximize the profit.
- Wealth maximization can be activated only with the help of the profitable position of the business concern

1.1.11 Importance of Restaurant Financial Management

After years of working in restaurants, Franklin decided that he was ready to open his own business. His years of working in the food service industry taught him the importance of carefully managing expenses if he wanted to be successful. So one of his first steps was to look for the right financial management software.

Franklin knew that he had to account for four basic categories of restaurant expenses:

- The food, which ranges from primary ingredients for menu items to preparation supplies such as cooking oil and spices.
- The staff, from servers to kitchen staff, managers, and janitorial workers.
- The venue or location, which includes rent or mortgage payments, utilities, taxes, and general upkeep.
- Overhead — the fixed costs that do not frequently change. This includes linens and uniforms, staff training and license fees, and marketing costs.

Profit margins in most restaurants tend to be razor-thin, averaging only 3 to 5 percent. Filing to manage these expenses can destroy a restaurant as quickly as a poor restaurant review!

Financial management software also contributes to building customer loyalty and the repeat business that are the cornerstones of successful restaurants. Keeping track of and keeping in touch with customers can be effectively managed by software and help contribute to the bottom line.

Having the right financial management software in place can also help owners and managers combat one of the biggest problems every restaurant faces — theft from employees. Billions of dollars are lost annually to employee theft in restaurants.

1.1.12 Restaurant Management Software

Two major types of restaurant financial management software include the following:

- **Front of the house** software focuses on interactions with customers. This is the software that handles things like reservations, input of orders, customer checks, payments, and customer behaviors.

- **Back of the house** software focuses on managing and monitoring the behind-the-scenes operations such as inventory management, supplier orders, employee scheduling, payroll, and overall analytics.

Within these two categories, a wide variety of software is available that can be incorporated based on the nature of the operation. All can help a restaurant more effectively manage cash flow, generate business, and improve profitability.

1.2 ACCOUNTING SPECIALTIES

There are several specialized areas within the accounting profession. For example, financial accounting 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. 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.

1.2.1 The Importance of Accounting to a Restaurant

An efficient back-office plays a critical role in the success of a restaurant. It is the system that takes care of your financial information and ensures that you are making enough revenue to cover your expenses. Even if you do not have a background in accounting, understanding this administrative area puts you in a better place of knowing how your business is performing.

As a restaurant owner, being aware of your business's financial health is an important factor in ensuring that you are not running your business blindly. With 50% of businesses failing within 5 years due to a lack of profits, understanding your finances can help you avoid major pitfalls. You will be able to see how your business is fairing in the market and take on challenges that come in raising income for your business.

What Is Accounting?

Accounting is the process of recording financial transactions pertaining to a business. The accounting process includes summarizing, analyzing and reporting these transactions to oversight agencies, regulators and tax collection entities. The financial statements used in accounting are a concise summary of financial transactions over an accounting period, summarizing a company's operations, financial position and cash flows.

Accounting refers to the collection, interpretation, classification, analysis, and reporting of financial data. It goes a notch higher than bookkeeping, which is just recording the financial transactions of the business.

Another way of looking at accounting is that it is the process of preparing and communicating the financial statements of a business entity. This includes communication of financial statements like income statements, balance sheets, and cash flow. Although the process is almost the same across many industries, it is quite different in the restaurant industry.

Restaurant accounting involves the collection, interpretation, and analysis of restaurant financial information. This includes the revenue of the restaurant, cashflow, inventory levels, and income statements. The process allows restaurant owners and managers to document all financial transactions of the business and determine how well it is performing.

A restaurant accountant is a professional who has specialized in restaurant accounting. They document all the financial transactions of the restaurant, keeping track of the inventory, cash flow, and income statements.

The information provided by restaurant accounting allows you to manage your cash more efficiently, predict your profits, balance your financial books, and plan for your business future. Now let's take a detailed look at how accounting is important to your restaurant.

Better Financial Management

For a business to be successful, it needs to have solid financial management. If you are running a restaurant, you need to have a way of accounting for the salaries paid to the employees, recording transactions, reporting total sales, and analyzing your restaurant. Without an efficient accounting system or function, such administrative areas of your business will be mismanaged and inefficient.

Accounting helps you get the necessary financial information needed for running every aspect of your business. This allows you to make proactive decisions and structure your business in a way that improves your profitability.

For you to run a successful restaurant business, you need data, reports, records, analysis, and accurate information about your finances. You need to know how much you have in your assets, your liabilities, and the amount of profit your business is making. Restaurant accounting allows you to have a clear picture of all this and manage your business in a better way: It involves:

- Business planning
- Budget preparation
- Tracking and managing cost of goods sold
- Tracking and managing labor costs
- Payroll
- Preparing daily sales reports
- Preparing financial statements like P&L and balance sheet

Provide Deeper Insights into Your Business Financial Status

Accounting information provides a deeper insight into the financial status of your business. Using real-time reporting of your restaurant's financial activities, you can regularly understand what is going on with your business. You will be able to determine which expenses cost you the most or which menu items are selling the best. This means you will be able to make better decisions and pursue strategies with greater outcomes. You also have a clear way of handling your business since you have a proper record of what is happening.

The two important financial statements that provide insights into your business financial status are the profit and loss (P&L) statement and the balance sheet. While the restaurant P&L shows the profitability of the business during a given period of time, the balance sheet shows how much your business is worth at a specific time.

A profit and loss statement provides you with a clear sense of how your restaurant business is currently performing financially. You will know how much you are spending on labor or creating each menu item, and your best and worst sellers. By showing you the profitability of your business, it allows you to determine areas of your business that need improvement. Since you can prepare this statement under various time periods like monthly or yearly, it allows you to make necessary adjustments and continuously monitor your business for growth.

The balance sheet provides a summary of your business assets, equity, and liability at a specific point in time. While the assets are what your business owns, the liabilities are what your restaurant owes others. Equity represents your net worth in the business and it is calculated by subtracting liabilities from the assets. If this figure is negative, it means that your restaurant liabilities are more than assets. This means that your business will not be able to fulfill all the liabilities by liquidating its assets if they all come due at the same time.

Better Tracking of Cash Flows

Good accounting practices allow restaurant owners and managers to track their business cash flows and record transactions. This is a critical factor in getting an accurate understanding of how the restaurant earns and spends money and the exact flow of it in and out of the business. Using such information, you can plan and allocate resources to specific divisions of your business to ensure it is running efficiently.

The cash flow statement shows the sources of your restaurant's cash and how you spent over a given period of time. Since this statement does not include any non-cash items, it gives a clear impression of the financial health of your business. It also helps you understand the difference between having cash on paper and actually having cash in your business accounts. This information is important in planning and forecasting the needs of the business. It allows you to introduce products and services that meet the needs of customers better and enhance your returns.

Control Your Prime Costs

Prime cost is among the most important key performance indicators (KPIs) of a restaurant business. It represents the total sum of your cost of goods sold or inventory and your labor costs. This is the cost incurred to ensure you have both the products and services needed for the restaurant to run. Controlling these costs is critical in keeping your business profitable.

Prime cost is what guides you in managing the day to day revenue of your restaurant to achieve a good profit margin. Restaurant accounting helps you analyze your prime costs to decide how much you are going to charge your services to make a profit. It also helps in calculating the amount of money that you can spend in running your business without compromising it. Monitoring costs is the first step in controlling them.

Tracking Inventory

Restaurant accounting plays a crucial role in ensuring accurate tracking of inventory and cost of goods sold. At any one time, you can tell what your ingredient stock count is, your current purchase orders, and the amount of money spent in purchasing the ingredients. When the accounting function has been integrated with a restaurant POS system, the process is fully automated. This means that you will have an easier and simplified way of calculating menu item costs, getting insights into the most profitable items, and monitoring your food waste and portioning.

Accurate tracking of your inventory will help you reduce food waste, budget mismanagement, customer dissatisfaction, and theft.

Help in Pricing Your Menu Items

Accounting helps in tracking costs and calculating how much money you spend on your restaurant. Among the important data that you derive from accounting is the cost of goods sold (COGS). This figure is crucial in determining the prices of your products and controlling your revenue. Knowing how accounting ratios are calculated and the impact of your COGS in determining the price you should place for your menu items. The price that you choose should be able to cover the cost incurred in preparing the meal. It should also generate a desired profit margin to ensure that your business is running at a profit.

Tracking of Your Restaurant Expenses

Your accounting system usually provides two types of information that can help you in tracking your expenses better. First, it shows the types of payments you make periodically, such as remitting taxes. Second, it shows the things that you pay for continuously throughout the life of your restaurant business. This includes your food costs, beverage costs, and labor costs and their relation to your sales. Each of these items is useful and important in controlling how much money you spend on your restaurant. In tracking these items, accounting helps you in keeping accurate records of:

- **Sales:** The amount of revenue that you make on a day to day basis. This can be broken down to food and beverage revenue, or be presented in categories of individual dishes depending on the type of restaurant that you are running. If you have good accounting software integrated into your restaurant POS, generating daily sales reports should be quite easy and straightforward.
- **Orders:** Accounting information shows how many orders your restaurant has received and how many were fulfilled. Apart from the sales made, you also need to find out how well your restaurant is meeting the needs of your customers. This is also a great approach to determining the amount of inventory your restaurant needs to run smoothly.
- **Payroll:** Payroll is all about what you pay someone else to work in your restaurant. As one of the key expenses of running a restaurant, you need to accurately track and manage how much you are paying your employees. Accounting provides such information, helping you to budget better.
- **Value of Inventory:** The value of inventory is not just about the physical or manual count of your inventory. It is also about how much revenue you can generate from the inventory and how to capitalize on it. Restaurant accounting can help you determine the amount of inventory you have on hand and estimate how much revenue can be generated from it.

Evaluate the Performance of Your Business

The accounting record of your restaurant reflects both the result of your operations and your financial position. This means you can identify areas that are performing well and those that require certain measures to improve. With several ratios being calculated from accounting information, you can analyze the performance of your restaurant and compare it with other players in the industry. You can also compare your current financial performance with previous accounting data to determine whether the business is moving in the right direction.

Ensure Your Restaurant is Compliant

Every business is required to be compliant with the laws of the land and taxation policies. Proper restaurant accounting ensures that your liabilities are paid and recorded on time. This includes statutory requirements like payment of sales tax, VAT, and income tax. You will be able to manage and monitor cash flow to ensure that money within your business is being directed to the right channels.

Bottom Line

The success of your restaurant business greatly depends on the accuracy of your financial records. Regardless of the size of your business, accounting helps in providing information showing where your business is headed. You can determine whether you are running a profitable business or measures need to be taken to achieve better financial outcomes.

REMEMBER

The Alliance for Responsible Professional Licensing (ARPL) was formed during August 2019 in response to a series of state deregulatory proposals making the requirements to become a CPA more lenient. The ARPL is a coalition of various advanced professional groups including engineers, accountants and architects.

How Accounting Works

Accounting is one of the key functions for almost any business. It may be handled by a bookkeeper or an accountant at a small firm, or by sizable finance departments with dozens of employees at larger companies. The reports generated by various streams of accounting, such as cost accounting and managerial accounting, are invaluable in helping management make informed business decisions.

The financial statements that summarize a large company's operations, financial position and cash flows over a particular period are concise and consolidated reports based on thousands of individual financial transactions. As a result, all accounting designations are the culmination of years of study and rigorous examinations combined with a minimum number of years of practical accounting experience.

While basic accounting functions can be handled by a bookkeeper, advanced accounting is typically handled by qualified accountants who possess designations such as Certified Public Accountant (CPA) or Certified Management Accountant (CMA) in the United States. In Canada, the three legacy designations—the Chartered Accountant (CA), Certified General Accountant (CGA), and Certified Management Accountant (CMA)—have been unified under the Chartered Professional Accountant (CPA) designation.

Requirements for Accounting

In most cases, accountants use generally accepted accounting principles (GAAP) when preparing financial statements in the U.S. GAAP is a set of standards and principles designed to improve the comparability and consistency of financial reporting across industries. Its standards are based on double-entry accounting, a method in which every accounting transaction is entered as both a debit and credit in two separate general ledger accounts that will roll up into the balance sheet and income statement.

Example of Accounting

To illustrate double-entry accounting, imagine a business sends an invoice to one of its clients. An accountant using the double-entry method records a debit to accounts receivables, which flows through to the balance sheet, and a credit to sales revenue, which flows through to the income statement.

When the client pays the invoice, the accountant credits accounts receivables and debits cash. Double-entry accounting is also called balancing the books, as all of the accounting entries are balanced against each other. If the entries aren't balanced, the accountant knows there must be a mistake somewhere in the general ledger.

History of Accounting

The history of accounting has been around almost as long as money itself. Accounting history dates back to ancient civilizations in Mesopotamia, Egypt and Babylon. For example, during the Roman Empire the government had detailed records of their finances. However, modern accounting as a profession has only been around since the early 19th century.

Luca Pacioli is considered "The Father of Accounting and Bookkeeping" due to his contributions to the development of accounting as a profession. An Italian mathematician and friend of Leonardo da Vinci, Pacioli published a book on the double-entry system of bookkeeping in 1494.

By 1880, the modern profession of accounting was fully formed and recognized by the Institute of Chartered Accountants in England and Wales. This institute created many of the systems by which accountants practice today. The formation of the institute occurred in large part due to the Industrial Revolution. Merchants not only needed to track their records but sought to avoid bankruptcy as well.

1.2.2 Financial Accounting

Financial accounting is a specific branch of accounting involving a process of recording, summarizing, and reporting the myriad of transactions resulting from business operations over a period of time. These transactions are summarized in the preparation of financial statements, including the balance sheet, income statement and cash flow statement that record the company's operating performance over a specified period.

Financial accounting refers to the processes used to generate interim and annual financial statements. The results of all financial transactions that occur during an accounting period are summarized into the balance sheet, income statement and cash flow statement. The financial statements of most companies are audited annually by an external CPA firm. For some, such as publicly traded companies, audits are a legal requirement. However, lenders also typically require the results of an external audit annually as part of their debt covenants. Therefore, most companies will have annual audits for one reason or another.

Work opportunities for a financial accountant can be found in both the public and private sectors. A financial accountant's duties may differ from those of a general accountant, who works for himself or herself rather than directly for a company or organization.

How Financial Accounting Works

Financial accounting utilizes a series of established accounting principles. The selection of accounting principles to use during the course of financial accounting depends on the regulatory and reporting requirements the business faces. For U.S. public companies, businesses are required to perform financial accounting in accordance with generally accepted accounting principles (GAAP). The establishment of these accounting principles is to provide consistent information to investors, creditors, regulators, and tax authorities.

REMEMBER

International public companies also frequently report financial statements in accordance with International Financial Reporting Standards.

The financial statements used in financial accounting present the five main classifications of financial data: revenues, expenses, assets, liabilities and equity. Revenues and expenses are accounted for and reported on the income statement. They can include everything from R&D to payroll.

Financial accounting results in the determination of net income at the bottom of the income statement. Assets, liabilities and equity accounts are reported on the balance sheet. The balance sheet utilizes financial accounting to report ownership of the company's future economic benefits.

1.2.3 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.

1.2.4 Managerial Accounting

Managerial accounting uses much of the same data as financial accounting, but it organizes and utilizes information in different ways. Namely, in managerial accounting, an accountant generates monthly or quarterly reports that a business's management team can use to make decisions about how the business operates. Managerial accounting also encompasses many other facets of accounting, including budgeting, forecasting and various financial analysis tools. Essentially, any information that may be useful to management falls underneath this umbrella.

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.

1.2.5 Tax Accounting

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 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.

1.2.6 Cost Accounting

Just as managerial accounting helps businesses make decisions about management, cost accounting helps businesses make decisions about costing. Essentially, cost accounting considers all of the costs related to producing a product. Analysts, managers, business owners and accountants use this information to determine what their products should cost. In cost accounting, money is cast as an economic factor in production, whereas in financial accounting, money is considered to be a measure of a company's economic performance.

1.3 USERS OF ACCOUNTING INFORMATION

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.
- **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.

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.

example

- **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.

1.4 GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (GAAPS)

Generally accepted accounting principles (GAAP) refer to a common set of accounting principles, standards, and procedures issued by the Financial Accounting Standards Board (FASB). Public companies in the United States must follow GAAP when their accountants compile their financial statements. GAAP is a combination of authoritative standards (set by policy boards) and the commonly accepted ways of recording and reporting accounting information. GAAP aims to improve the clarity, consistency, and comparability of the communication of financial information.

GAAP may be contrasted with pro forma accounting, which is a non-GAAP financial reporting method. Internationally, the equivalent to GAAP in the United States is referred to as International Financial Reporting Standards (IFRS). IFRS is followed in over 120 countries, including those in the European Union (EU).

DID YOU KNOW ?

Generally Accepted Accounting Principles began to be established with legislation such as the Securities Act of 1933 and the Securities Exchange Act of 1934.

GAAP helps govern the world of accounting according to general rules and guidelines. It attempts to standardize and regulate the definitions, assumptions, and methods used in accounting across all industries. GAAP covers such topics as revenue recognition, balance sheet classification, and materiality.

The ultimate goal of GAAP is to ensure a company’s financial statements are complete, consistent, and comparable. This makes it easier for investors to analyze and extract useful information from the company’s financial statements, including trend data over a period of time. It also facilitates the comparison of financial information across different companies.

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

GAAPs include:

- **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!
- **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.

Keyword

Liability is defined as the future sacrifices of economic benefits that the entity is obliged to make to other entities as a result of past transactions or other past events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future.

Keyword

Fair value is the estimated price at which an asset can be sold or a liability settled in an orderly transaction to a third party under current market conditions.

- **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 tocease 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.
- **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.
- **Expenses matched to revenues.** Expenses that are incurred must be matched with, and deducted from, revenues that are generated in 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).
- **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.

- **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.
- **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.

1.5 POSITIONS WITH ACCOUNTING RESPONSIBILITIES

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

- **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.

1.6 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:

- Performance standards (expectations) must be established. (This is done as the operating budget is developed.)
- Actual financial information must be collected to measure the results of operation.
- Comparisons must be made between expected performance (Step 1) and actual performance (Step 2).
- 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.
- 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.

1.7 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.

CASE STUDY

FINANCE SOFTWARE COMPANY WINS ENTERPRISE CONTRACT WITH CLIENT-BASED CLOUD SOLUTION

"Windows Azure has brought our product to life. 360Lifecycle is more cost-effective and secure, requires less support, and is faster to deploy. We can market the product to companies of any size."

Paul Merrigan, Chief Executive Officer, Lifetime Financial Management

Lifetime Financial Management wanted to reduce support costs and expand the target market for its customer relationship management (CRM) application 360 Lifecycle. Dot Net Solutions helped Chief Executive Officer Paul Merrigan and his team migrate the rich-client solution to run on the Windows Azure platform. Since then, Merrigan has significantly cut support costs and won a five-year contract with intrinsic financial services.

Business Needs

In 2004, Merrigan asked software developer David Steele to create an application to support his mortgage advisors in managing customer opportunities. At the time, Merrigan had worked in the financial services industry for 15 years and was confident that he had the experience and skills to understand the needs of advisors. Together with Steele, he created an in-house CRM application called 360 Lifecycle, which proved to be a highly valuable addition to the business. Merrigan says: "At the height of the global recession in 2008, our business prospered because 360 Lifecycle provided an easy way for advisors to manage customer relationships, while highlighting new business leads and opportunities." The software alerted employees to business opportunities that they might otherwise have missed due to their large customer portfolios. This success attracted the attention of competitors, which were soon asking Merrigan why his company was doing so well during such a difficult time. This inspired the company to market the software as a standalone product for other financial advisory businesses. In 2009, Lifetime Financial Management attracted its first customer for 360 Lifecycle—a firm of 30 advisors—and within months another nine customers had subscribed to the software. Merrigan had found a significant new business stream, but the sudden interest and accumulation of customers came with a large support requirement—something for which the company had not had time to plan.

Each customer wanted to purchase its own servers to host the application, and it took up to a week for Lifetime Financial Management to provision servers for each customer. Merrigan dedicated two employees to deal with support requirements, but as the number of users increased, it became a challenge for the company to keep up with the volume of general enquiries and product and security updates.

Solution

In 2010, Merrigan contacted Dot Net Solutions for advice on the next stage of development for 360Lifecycle. The Microsoft Partner is an expert on the Windows Azure platform, and was confident that the client software could be developed as a software-as-a-service application in the cloud. Dan Scarfe, Chief Executive Officer at Dot Net Solutions, says: "The goal was to transform 360Lifecycle from a single-tenant to a multi-tenant cloud-based architecture. We arranged for the Lifetime Financial Management development team to be involved in a three-week proof of concept (POC) and training session at the Microsoft Technology Centre in Reading."

The aims of the POC were to demonstrate the scalability and performance gains to be made by developing the software with Windows Azure. Scarfe says: "It is a common misconception that desktop clients cannot work in the cloud. The POC showed Lifetime Financial Management that the application was both highly scalable and performed better in the cloud."

360Lifecycle software is now run as a cloud-based service downloaded onto a laptop, computer, or tablet PC. 360Lifecycle servers are hosted in Microsoft data centers, providing 99.99% uptime. New customers do not need to purchase hardware to host the service, and can be provisioned in less than a minute. Once an update or new functionality is configured, Merrigan's team deploys it to all customers at the same time. Windows Azure is financed on a pay go basis and Lifetime Financial Management only pays for what its customers consume.

By January 2011, all customers were migrated to the cloud-based service. Scarfe says: "We completed most of the project within eight weeks. It was a rapid turnaround from initial discussion to seeing the product go live. Customer migration was completed in stages, and customers did not experience any disruption to service."

Benefits

Lifetime Financial Management recently won a contract supporting up to 2,000 users at Intrinsic Financial Services. According to Merrigan, attracting enterprise customers such as Intrinsic is only possible by delivering the product as a cloud-based service. He says: "Windows Azure has brought our product to life. 360 Lifecycle is more cost-effective and secure, requires less support, and is faster to deploy. We can market the product to companies of any size."

Cloud finance model increases profit margins. Lifetime Financial Management pays for what it consumes and can tailor pricing to suit its understanding of customer use. "Our contract with Intrinsic Financial Services is to support up to 2,000 users for five years," he says. The contract is charged on a per-user, per-month basis, and Lifetime Financial Management has no plans to expand the support team.

Small support team manages thousands of customers. The 360 Lifecycle team can configure new customers in less than two minutes, and deploy updates and functionality at the click of a mouse. Merrigan says his team is now equipped to manage the support requirements for thousands of customers. "The application runs a lot faster now that it is hosted on web servers in Microsoft data centers, and it comes with a Microsoft SLA of 99.99 % uptime, which we pass on to our customers," he says.

Scalable software expands potential market. For small businesses, hardware costs are often a barrier to purchasing the software they need, while for large businesses, flexibility and scalability are crucial. Merrigan says: "360 Lifecycle on Windows Azure addresses both market concerns by removing the upfront hardware costs and incorporating them into a manageable, monthly fee per user. For large businesses, server provisioning is managed at the click of a mouse, and performance is adjusted to suit application use."

Questions

1. What do you mean by business needs?
2. Explain the benefits of lifetime financial management.

SUMMARY

- Financial management may be defined as the area or function in an organization which is concerned with profitability, expenses, cash and credit, so that the "organization may have the means to carry out its objective as satisfactorily as possible;" the latter often defined as maximizing the value of the firm for stockholders.
- 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.
- 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.
- Front of the house software focuses on interactions with customers. This is the software that handles things like reservations, input of orders, customer checks, payments, and customer behaviors.
- Back of the house software focuses on managing and monitoring the behind-the-scenes operations such as inventory management, supplier orders, employee scheduling, payroll, and overall analytics.
- Accounting refers to the collection, interpretation, classification, analysis, and reporting of financial data. It goes a notch higher than bookkeeping, which is just recording the financial transactions of the business.
- Financial accounting refers to the processes used to generate interim and annual financial statements. The results of all financial transactions that occur during an accounting period are summarized into the balance sheet, income statement and cash flow statement.
- 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.
- 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.
- 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.

MULTIPLE CHOICE QUESTIONS

1. **The only feasible purpose of financial management is ....**
   a. Wealth Maximization
   b. Sales Maximization
   c. Profit Maximization
   d. Assets maximization
2. **Financial management process deals with ....**
   a. Investments
   b. Financing decisions
   c. Both a and b
   d. None of the above
3. **Financial management is mainly concerned with ....**
   a. Arrangement of funds
   b. Profit maximization
   c. Efficient Management of every business
   d. All aspects of acquiring and utilizing financial resources for firms activities
4. **The primary goal of financial management is ....**
   a. to maximize the return
   b. to minimize the risk
   c. to maximize the wealth of owners
   d. to maximize profit
5. **What is the main purpose of financial accounting?**
   a. Minimize company taxes
   b. Organize Financial Information
   c. Provide useful Financial information to outsiders
   d. Keep track of Company expenses

Review Questions

1. What is the simple meaning of finance? Describe the types of finance.
2. Define the financial management. What are the importance of financial management?
3. Describe the types of restaurant financial management software.
4. What are the relationship between manager and accountant?
5. Write the short notes on following:
   - Financial accounting
   - Managerial accounting
   - Tax accounting.

Answer to Multiple Choice Questions

1. (a) 2. (b) 3. (d) 4. (c) 5. (c)

REFERENCES

1. Alexander, D., Britton, A., Jorissen, A., "International Financial Reporting and Analysis", Second Edition, 2005, ISBN 978-1-84480-201-2
2. Clive Marsh (2009). Mastering Financial Management, Financial Times Prentice Hall ISBN 978-0-273-72454-4
3. David Annand, Introduction to Financial Accounting, Athabasca University, ISBN 978-0-9953266-4-4
4. Fred., Phillips (2011). Fundamentals of financial accounting. Libby, Robert., Libby, Patricia A. (3rd ed.). Boston: McGraw-Hill Irwin. ISBN 9780073527109. OCLC 457010553.
5. James Van Horne and John Wachowicz (2009). Fundamentals of Financial Management, 13th ed., Pearson Education Limited. ISBN 9705614229
6. Johnny Jackson, Introduction to Financial Accounting, Thomas Edison State University.
7. Lawrence Gitman and Chad J. Zutter (2019). Principles of Managerial Finance, 14th edition, Addison-Wesley Publishing, ISBN 978-0133507690.

CHAPTER 2

DEBITS AND CREDITS-THE MECHANICS OF ACCOUNTING

"Accounting does not make corporate earnings or balance sheets more volatile. Accounting just increases the transparency of volatility in earnings".

- Diane Garnick

INTRODUCTION

Business transactions are events that have a monetary impact on the financial statements of an organization. When accounting for these transactions, we record numbers in two accounts, where the debit column is on the left and the credit column is on the right.

- A debit is an accounting entry that either increases an asset or expense account, or decreases a liability or equity account. It is positioned to the left in an accounting entry.

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

1. Explain the types of business transactions
2. Understand the types of accounts
3. Describe the concept of restaurant accounting
4. Define the terms debits and credits
5. Discuss the accounting cycle
6. Deal with specialized journals

- A credit is an accounting entry that either increases a liability or equity account, or decreases an asset or expense account. It is positioned to the right in an accounting entry.

Keyword

Business transaction is an event involving an interchange of goods, money or services between two or more parties.

We introduce the single accounting equation that describes what a restaurant owns compared to what it owes:

Assets = Liabilities + Owners' Equity

This basic equation drives all financial records relating to the restaurant.

You will also learn how the accountant or bookkeeper creates "T" accounts to permit the easy recording of changes in assets, liabilities, and owners' equity. Increases and decreases in these accounts are achieved by adding to or subtracting from each account. You will learn how and why this is done as you examine the concept of debiting and crediting T accounts to keep them in balance.

Additional procedures used by an accountant to maintain aspects of the accounting equation are presented so you can learn how sales levels, inventories, depreciation of assets, and other financial aspects of the restaurant are accounted for. In addition, the concept of posting (recording) financial information to the variety of summary account records (ledgers) used in a restaurant will be discussed.

Finally, you will review the accounting cycle: the entire process of recording all bookkeeping entries that affect the basic accounting equation and then preparing financial statements based on these entries.

Financial statements prepared by the accountant are the end product of a process, comparable to plated food prepared by the chef. If the food is not liked by a guest, future sales to this guest are doubtful. Likewise, if financial statements do not yield relevant and useful information, they will likely be ignored in the future

Many important details must be addressed as accounting systems are designed and as financial statements are developed.

This can be complicated, and in the case of tax regulations, ever-changing. The purpose of this chapter is not to make the busy restaurant manager a professional accountant. Rather, it is to review the basics of accounting that comprise only one aspect of the manager's responsibilities. These basics should be incorporated into the restaurant's procedures for collecting, assembling, reporting, and using **financial information**.

Keyword

Financial information is data about the monetary transactions of a person or business. This information is use to derive estimates of credit risk by creditors and lenders.

2.1 TYPES OF BUSINESS TRANSACTIONS

A business transaction is an economic event with a third party that is recorded in an organization's accounting system. Such a transaction must be measurable in money.

Examples of business transactions are:

Every day, innumerable business transactions occur in restaurants. There is an exchange of cash to purchase food from suppliers, and guests use credit cards or cash to pay for their meals. These are simple business transactions. A business transaction generally involves some type of an exchange. In the examples just presented, one exchange involved cash and another involved a credit card. Certain events occur that change the value of the business but do not involve transactions. For example, as an equipment item wears out, periodic accounting adjustments called depreciation are made. Likewise, accounts receivable that cannot be collected require an accounting adjustment for bad debt expense. The job of the accountant is to record transactions and other events that result in the changes in the "value" of the business.

2.1.1 Basic Accounting Equation

The "things" owned by a restaurant are called assets and commonly include cash, accounts receivable, equipment, land, buildings, food/beverage inventories, and investments. Some assets are given to the restaurant by its owners; other assets might be obtained by borrowing money from a bank or other lenders. There are, then, two groups who have claims to the restaurant's assets—owners and lenders. Broadly speaking, claims to assets are called equities. Therefore, the assets of the restaurant equal its equities.

Equities are commonly divided into two groups:

- Ownership claims to assets are called owners' equity if the restaurant is unincorporated. If the restaurant is a corporation, the term "stockholders' equity" is used. (One owner of an unincorporated business may be referred to as "proprietor"; two or more owners may be called "partners.")
- Claims of outside parties such as financial institutions and suppliers are referred to as liabilities. The sum of owners' equity and liabilities (external parties' equity) must equal assets.

Now all elements in the basic accounting equation have been presented: assets, liabilities, and owners' equity. The basic accounting equation is:

Assets = Liabilities + Owners' Equity

If the debts of a restaurant (liabilities) are subtracted from its assets, the result equals owners' equity. Liabilities represent the first claim to assets. When they are subtracted from assets, owners' equity (the residual claim to assets) remains. We can rearrange the basic accounting equation to show this:

Assets – Liabilities = Owners' Equity

A basic financial statement of the restaurant (the balance sheet) reflects the fundamental accounting equation; assets must equal (balance against) the liabilities and owners' equity.

2.1.2 Revenue and Expenses Impact Owners' Equity

The restaurant's goal is to generate profit. Profit (net income) results when revenues exceed expenses. Revenues increase owners' equity; expenses reduce owners' equity. Assume that a dinner is sold for $15.00 in cash and that related expenses (food costs, labor costs, supplies, etc., are purchased with $10.00 in cash). The net result is an increase in cash of $5.00 ($15 – $10 = $5) and an increase in owners' equity by $5.00. The sales transaction by itself would be an increase in both cash and owners' equity of $15.00. The purchase (expense) transactions would reduce both cash and owners' equity by $10.00 each.

Note that owners' equity has increased by the amount of profit of $5. (Revenue of $15 less expenses of $10 equals profit of $5.) The increase in assets of $5 is in the cash account since both transactions involved cash. Also note that the balance between assets and claims to assets remains intact.

2.2 TYPES OF ACCOUNTS

All transactions affect the basic accounting equation and are recorded in accounts. An account is a device for recording increases and decreases in a single asset, liability, or owners' equity item. The T account, named for its shape, is a simple way of illustrating an account as follows:

Name of Account	
(Left side)	(Right side)

Asset accounts are increased by entries on the left side of the account and decreased by entries on the right side. The reverse is true for equity accounts; liability and owners' equity accounts are increased by entries on the right side of the account and decreased by entries on the left side. This may be shown as follows:

ASSET ACCOUNT	
Increases	Decreases

LIABILITY ACCOUNT	
Decreases	Increases

OWNERS' EQUITY ACCOUNT	
Decreases	Increases

REMEMBER

All transactions must be recorded in accounting records, and each transaction must be carefully analyzed to determine its effect on the business. After analysis, the transaction must be properly recorded in the accounting records of the restaurant.

2.2.1 Asset Accounts

- *Cash on hand*. This account includes house funds (such as petty cash) and cash register banks.
- *Cash on deposit*. This account is the restaurant's bank account. If more than one bank account is used (example: one for general disbursements and another for payroll) separate accounts should be established 'for each on the books of the restaurant.
- *Accounts receivable*. This account is mainly used to record amounts due from guests. Amounts due from officers and employees, rentals, and commissions are also receivables but should be maintained in separate receivable accounts.
- *Allowance for doubtful accounts*. This account provides a reserve for probable losses when receivables are not collected.

- *Notes receivable*. Promissory notes from officers and employees are included in this account.
- *Inventories*. A separate account should be maintained for each type of inventory. Food inventory consists of the cost of food on hand in the storeroom, pantries, kitchens, freezers, etc. Beverage inventory consists of stock at the bars, in the storeroom, etc. Separate inventory accounts should be maintained for other merchandise for sale and for cleaning, office, and other supplies.
- *Marketable securities*. This is an account for recording investments made on a temporary basis using surplus cash. Investments of a permanent nature should be recorded in an account called "investments.
- *Prepaid expenses*. A separate account should be established for each prepaid expense item such as rent, licenses, and unexpired insurance.
- *Investments*. This account is used to record assets that are not readily liquidated. Examples include long-term stocks and bonds, which are usually reported at cost.
- *Land*. This account is used to record land purchased that is used in the business.
- *Building*. This account is used to record the purchase of buildings used by the restaurant.
- *Equipment*. This account is used to record the purchase of equipment.
- *Furniture*. This account is used to record the purchase of furniture.
- *China, glassware, silver, and linen*. This account is used to record the purchase of china, glassware, silver, and linen. (Alternatively, many restaurants expense these items when purchased.)
- *Accumulated depreciation*. This account is used for recording depreciation over the useful life of an asset such as equipment.
- *Deposits*. Deposits with utility companies for water, gas, etc., should be recorded in this account.

2.2.2 Liability Accounts

- *Accounts payable—trade*. This account is used to record amounts due to suppliers of goods and services in the restaurant's ordinary course of business.
- *Accounts payable—others*. Amounts due concessionaires representing collections from guests or extraordinarily large open accounts (such as might result from equipment purchases) are shown in this account.
- *Notes payable*. This account is used for short-term notes owed by the restaurant.
- *Taxes payable*. This group of accounts (one for each type of tax) is established

to record taxes due to government authorities. Examples include federal, state, and city withholding payables, FICA (social security) payable, sales taxes payable, and federal and state income taxes payable.

- *Deposits on banquets*. This account is used for recording deposits made by guests for future banquets/parties.
- Accrued expenses. This group of accounts is maintained for recording the amounts payable for expenses incurred at or near the end of an accounting period, including accrued payroll, utilities, interest, and rent.
- *Dividends payable*. This account is for recording dividends payable based on formal declaration of dividend action by the board of directors. Note: This account is not applicable to unincorporated businesses.
- *Long-term debt*. This group of accounts is to record debt that is not due for 12 months from the balance sheet date, including mortgage payable, notes payable, and bonds payable. A separate account is established for each debt.

2.2.3 Equity Accounts

For sole owner (proprietorships) or multiple owners (partnerships):

- (Name of Proprietor or Partner), Capital. This account shows the owners' net worth in the restaurant. The initial investment less withdrawals and operating losses plus operating profits results in the balance. If the business is organized as a partnership, a separate account is maintained for each partner.

For Corporations

- *Capital stock*. This group of accounts is used for recording each type of stock issued.
- *Paid-in capital in excess of par*. This account is used for recording proceeds from sale of capital stock in excess of the par value. A separate account should be established for each type of stock.
- *Retained earnings*. The amount of earnings retained in the restaurant is recorded in this account.

Revenue:		
Food sales	Beverage sales	Dividend income
Beverage sales	Interest income	

Expenses:		
Cost of food sales	Uniforms	Cleaning supplies
Cost of beverage sales	Laundry	Guest supplies
Payroll	Linen rental	Bar supplies
Employee benefits	China and glassware	Menus
Payroll taxes	Silverware	Provision for doubtful accounts
Dry cleaning	Electricity	Painting/decorations
Contract cleaning	Fuel	Repairs expense
Flowers and decorations	Water	Rent
Automobile expense	Waste removal	Real estate
Freight	Office supplies	Capital stock tax
Parking	Postage	Interest expense
Licenses and permits	Telephone	Depreciation
Professional entertainers	Data processing costs	Amortization
Piano rental	Insurance	Income taxes
Newspaper advertising	Professional fees	
Direct mail	Franchise fees	
Outdoor signs	Collection fees	
Donations	Kitchen fuel	

Revenue and expense accounts are really temporary owners' equity accounts, because they are closed out each period to the permanent owners' equity accounts. These accounts are extremely important for collecting financial information for management decisions.

2.3 RESTAURANT ACCOUNTING

Effective accounting for restaurants is one of the most important aspects of making your business successful. Since the profit margins in restaurants are slim, it is important to keep a watchful eye on the bookkeeping process.

What makes restaurant accounting unique is the language of hospitality finance. For efficient accounting, you need to understand the ins and outs of how the food and beverage industry.

Restaurants have their own special accounting needs and quirks:

- Cash and accrual are the two accounting methods used for restaurant accounting.
- Restaurants benefit from doing inventory and profit and loss statements weekly.

- Two ratios – food/beverage to expenses and revenue per seat – are helpful for restaurant accounting.

You might think accounting is the same across the board, but it can differ quite a bit from industry to industry.

So what sets restaurant accounting apart? On the surface, it's not all that different from standard accounting practices – restaurant accounting uses many of the same costing methods, as well as profit and loss statements and cash flow reports, just like many other industries do. However, much like a restaurant comes with its unique expenses, restaurant accounting has its nuances.

The easiest way for a restaurant to maintain its books is by using business accounting software.

Here are some of the main things you need to know:

Accounting methods

Like other industries, restaurants can use the cash method or the accrual method to do their accounting, though there are some subtle differences. Restaurants that generate less than $1 million per year can choose their method, but those that generate more than $1 million must use the accrual method.

Cash method

The **cash method** is the most common accounting method for restaurants because customers pay for their food and services rendered right away. That means they do not owe you money later on (like what might happen with a construction project). This also means restaurants probably will not have an accounts receivable balance. With this method, activities are simply recorded when payment is received. While this might be the easiest method for restaurants, it's not necessarily the most accurate.

Accrual method

The accrual method, on the other hand, records transactions as they happen, regardless of when payment occurs, which allows for a different analysis of activity, shows a more accurate perspective of how expenses are incurred and income is generated, and how income compares to expenses.

However, that does not mean you do not need to consider them in your accounting process. Employees at your restaurant are still required to report tips to you, and both they and you are required to pay taxes on them – you just do not need to report them as part of your restaurant revenue.

Accounting periods

Since the day of the week tends to affect business (for example, a Friday night might be busier and bring in more customers, thus making you more money than a quiet Tuesday), it's useful for restaurants to use a four-week accounting period instead of a monthly accounting period, according to Orderly.

A four-week accounting period would look at four weeks at a time, each starting on a Monday and ending on a Sunday. That way, you can combine time periods from year to year. July of last year and July of this year would have a different number of Fridays and Saturdays. In other industries, this would not be a big deal, but it's essential to note in the restaurant business.

Types of restaurant expenses

Like any business, restaurants will have fixed and fluctuating expenses. Fixed expenses are often cost of operations, including rent, utilities, insurance, loan payments, and salaried employees are all fixed expenses.

Fluctuating expenses are more difficult to budget because they change frequently. Hourly wages for employees and food costs are the largest fluctuating expenses. Profits will vary as well, so it's important to use percentages instead of only a fixed dollar amount.

Your labor and food costs will be higher if you have a busy week and sales are $10,000 vs a slow week when sales are $5,000. Keep labor and food costs at 30% of sales each to stay profitable.

Inventory management

While other businesses, like retail stores, might not need to take stock of their inventory on such a frequent basis (many businesses can get away with doing so monthly, quarterly or even once a year), restaurants need to monitor their inventory weekly. Why? Because restaurant inventory is food, much of which is perishable and will spoil before a month is over.

The **cost of goods sold** (COGS) is also an important part of inventory management. Lowering COGS is an excellent way to increase profits.

Start with categorizing your items. Meats, dairy, and fruits for example. You can then set a percentage for each group, which makes it easier to manage.

It's also important to minimize waste. Measure ingredients carefully, and ensure that all employees do the same. If a recipe calls for one-quarter cup cheese, but a half cup is consistently used, this can double your cost for cheese. These expenditures add up to a significant impact.

Keyword

Cost of goods sold is the carrying value of goods sold during a particular period. Costs are associated with particular goods using one of the several formulas, including specific identification, first-in first-out, or average cost.

Cash flow and profit and loss statements

Like with inventory, some businesses might do profit and loss statements on a monthly or quarterly basis (though you can do them as often as feels necessary). Weekly profit and loss statements are smart for restaurants because it can help with managing inventory. Cash flow reports should also be more frequent for the same reason.

Important restaurant ratios

There are several ratios relevant to the restaurant industry. A few of these are food/beverage to expenses and revenue per seat.

Food and beverage expenses to sales ratio can tell you how much profit you are making from a specific menu item. You will take the cost of the ingredients needed to make the dish one time and divide it by the menu cost of the item. The food cost should be 30% or less.

Some items will provide you with a lower food cost to profit ratio than others. Once you identify these items, consider promoting them or offering them as suggestive sales.

Revenue per seat is calculated by dividing the revenue from a given day by the number of seats. This can be helpful when considering renovation or downsizing. If revenue per seat is lower on certain days or periods, consider closing an area to decrease the available seating in these periods.

More seating requires more employees and increased utilities, so closing an area can result in significant savings. If you are often filled to capacity, you will have high revenue per seat. In these situations, it can be beneficial to offer more seating to make room for more customers.

2.3.1 How to do Bookkeeping for a Restaurant?

Setting Up Your Books

1. Find the ideal bookkeeper

As an owner, you know the challenges of running a restaurant such as dealing with staffing, inventory management and controlling the cost of goods sold. It is important to find a bookkeeper who understands the complexity of the food and beverage industry, both front-of-the-house operations and back-of-the-house management.

2. Use an accounting software

Choose accounting software to streamline your data entry tasks, create customized invoices, track your revenue, create regular profit and loss statements and review your cash flow. The ideal bookkeeping software for restaurants should offer robust reporting features, be easy to use and allow you to access data anytime, anywhere.

3. Set up the chart of accounts

The next step is to set up your chart of accounts which is used to categorize the money flowing in and out of your business. A standard chart of accounts includes assets, liabilities, expenses, revenue and owner's equity.

This is further broken down into business-specific categories such as inventory, sales and marketing. While setting up the chart of accounts, it's important to decide the metrics you want to monitor.

4. Choose a POS system

Whether you are running a small bakery or a fine dining restaurant, you would need a POS system for cash management, sending receipts via text or mail, inventory management, order management and back-office reporting.

Choose a system that is easy to use for employees and customers and those ties in with your accounting software.

What You Need to Track

Payroll

Payroll in the restaurant industry can be challenging as the process of tracking employee hours is complex. Multiple wages and staff positions are the norms in the restaurant industry and the ability to accommodate different rates is key.

There are 14.7 million people in the restaurant industry. Ten percent of the workforce in the United States is made of restaurant employees and most of these employees are hourly and part-time staff.

With irregular work hours, multi-positions and different types of pay, calculating restaurant payroll can be a hassle. It is best to outsource the payroll function or use payroll software to do the work for you.

Accounts Payable

Paying your bills on time and keeping your vendors and suppliers happy is essential for the efficient functioning of a restaurant. The accounts payable represents the amount you owe the suppliers.

Once you receive invoices, update them on the accounting software. This will help you keep track of the payment schedule.

Inventory

Based on the size of your restaurant, you can set up an inventory management system that optimizes food costs and reduces waste. The inventory also helps you avoid food shortages and surpluses. Track your consumables and supplies to calculate the value of the food you have in stock and determine the average daily inventory costs.

Cash Management

Monitor your cash flow, which refers to the amount of cash coming in versus the amount of cash going out of your business on a daily, weekly and monthly basis.

Sales

Keeping track of your revenue is important to restaurant bookkeeping. Use the accounting records on hand to show how much you earn from food sales, merchandise sales, or catering jobs. Find out how much revenue you make each day and ideally break them further into food and beverage categories.

Reconciliation

You must reconcile all of your accounts, including bank accounts, loans, credit cards, lines of credit and even your payroll liabilities. Reconciling will ensure that you've accounted for everything.

Reporting and Analysis

Here are some key ratios to consider when reviewing the financial statements of your restaurant, specifically your weekly and monthly income statements.

Food Costs

The cost of preparing the item on menu divided by the total revenue from the item. This ratio is used to ensure that you are making the profit from each menu item.

How to calculate:

Food cost / Total sales x 100

Prime Costs

Prime cost is a summation of all your labor costs and your cost of goods sold. Paying your restaurant staff, including front-of-office staff and kitchen crew, are part of your labor costs. It also includes benefits, payroll taxes, etc.

Ideally, labor should be less than 30 percent of the revenue. Depending on the type of restaurant you run, though, costs may be higher or lower. To evaluate the costs, divide the staff into groups of kitchen staff or managers to see which group is costing you more.

How to calculate:

Labor + Cost of goods sold

Overhead Rates

Overhead rates are fixed costs of running your business such as rent and insurance. It is calculated on an hourly, daily or monthly rate. This will give you an insight into how much your business costs to run.

How to calculate:

Total fixed costs/ Total operating hours

Cost of Goods Sold

The cost of goods sold represents the inventory at a given time. It helps you understand how much you are spending to make the food.

How to calculate:

Beginning inventory + purchased inventory – final inventory

Gross Profit

After the payment of all business-related expenses, the amount of money leftover at the end of every month is your gross profit.

How to calculate:

Total sales – total expenses

2.4 DEBITS AND CREDITS

It is awkward to say “record on the left side of a T account” or “record on the right side of a T account.” Therefore, the accounting concepts of debits (abbreviated “Dr.”) and credits (abbreviated “Cr.”) have been established. For example, when cash is increased by $10, rather than say “record $10 on the left side of the cash account,” one can just “debit cash for $10.”

Definitions

Debit simply is an entry on the left side of an account, while credit is simply an entry on the right side of an account. Debits are increases to some accounts but decreases to others; credits increase certain accounts but decrease others.

The effect that debits and credits have on the major categories of accounts follow:

ASSETS		LIABILITIES		OWNERS' EQUITY		REVENUES		EXPENSES	
+	–	–	+	–	+	–	+	+	–
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.	Dr.	Cr.

Note that debits increase asset and expense accounts but decrease liability, owners' equity, and revenue accounts. On the other hand, credits increase liability, owners' equity, and revenue accounts but decrease asset and expense accounts.

All transactions are recorded with at least one debit and one credit entry, and in all cases, the total of debits must equal the total of credits for an entry. When Luis purchased his equipment, he paid $1,000 in cash and signed for a notes payable for $9,000. The debit of $10,000 to the equipment account is equal to the sum of the credits of $1,000 to the cash account and $9,000 to the notes payable account.

DID YOU KNOW ?

Debits and credits accounts were formally invented in the 15th century by Luca Pacioli, as an official system to specify what was already used by merchants in Venice.

2.4.1 Types of Accounting Transactions

There are nine possible types of accounting transactions that affect the three major types of accounts: assets, liability, and owners' equity.

Illustrations of these nine types of transactions follow:

1. *Increase one asset and decrease another asset*. Example: Equipment is purchased for $500. (Dr. Equipment and Cr. Cash)
2. *Increase an asset and increase a liability*. Example: $1,000 in cash is borrowed from the bank. (Dr. Cash and Cr. Notes payable)
3. *Increase an asset and increase an owners' equity account*. Example: The owner invests $1,000 in the business. (Dr. Cash and Cr. Owner, Capital)
4. *Increase one liability and decrease another liability*. Example: A note is made in exchange for an account payable. (Dr. Accounts payable and Cr. Notes payable)
5. *Decrease a liability and decrease an asset*. Example: A supplier is paid on account. (Dr. Accounts payable and Cr. Cash)
6. *Increase a liability and decrease an owners' equity account*. Example: Dividends are declared. (Dr. Retained earnings and Cr. Dividends payable)

7. *Decrease an asset and decrease an owners' equity account*. Example: Cash is withdrawn by the proprietor. (Dr. Owner, Capital and Cr. Cash)
8. *Decrease a liability and increase an owners' equity account*. Example: Long-term debt owed to the sole proprietor is converted to owners' equity. (Dr. Long-term debt and Cr. J. Doe, Capital)
9. *Increase an owners' equity account and decrease another owners' equity account*. Example: Preferred stock is converted to common stock. (Dr. Preferred stock and Cr. Common stock)

It is not possible to make entries that only

- Increase an asset and decrease a liability.
- Decrease an asset and increase a liability.
- Increase a liability and increase an owners' equity account.
- Decrease a liability and decrease an owners' equity account.
- Decrease an asset and increase an owners' equity account.
- Increase an asset and decrease an owners' equity account.

Determining Entries for a Transaction

There is a simple three-step procedure to determine entries in recording a business transaction:

1. Determine which accounts are affected.
2. Determine whether to debit or credit the accounts.
3. Determine the amounts to be recorded.

Step 1: (Affected accounts?) Equipment is obtained, and cash is disbursed.

Step 2: (Debit or credit?) Since the equipment account (an asset) increased, the account must be debited; cash is decreased so it must be credited.

Step 3: (Amount?) The accounts should be debited and credited for $3,000 each.

Account Balances

To determine an account balance, the debits and credits in the account must be totaled, and the lesser of the two is subtracted from the larger. An account has a debit balance if the sum of the debits for the account exceeds the sum of the credits for the same account. Conversely, an account has a credit balance if the sum of the credits for the account exceeds the sum of the debits for the same account.

In the following illustration for Luis's, the cash account has a debit balance of $1,755. The two debit entries total $5,015, and the three credit entries total $3,260. Since the debits exceed the credits, the balance of $1,755 is called a debit balance. The debit balance for the cash account is normal; that is, asset accounts generally have debit balances. The normal balance for the five major types of accounts is as follows:

Type of Account	Normal Balance
Asset	Debit
Liability	Credit
Proprietorship	Credit
Revenue	Credit
Expense	Debit

Keyword

Trial balance is a list of all the general ledger accounts contained in the ledger of a business.

Trial Balance

A **trial balance** is a listing of all accounts with their debit and credit balances. A trial balance is prepared at the end of an accounting period and is the first step in developing financial statements. The trial balance of accounts is "in balance" when the total of the debit balance accounts equals the total of the credit balance accounts. A trial balance provides proof that the debits equal the credits. (Still, problems may exist. For example, an amount may have been recorded in the wrong account, but the trial balance would still be in balance.)

A trial balance is prepared in four steps:

Step 1: Determine the balance of each account.

Step 2: List all accounts, placing debit and credit balances in separate columns.

Step 3: Sum the debit and credit columns separately.

Step 4: Compare the total of the debit and credit columns.

2.5 MEASURING INCOME

To this point, revenue and expense concepts have only been mentioned briefly. However, the major purpose of a restaurant is to generate a profit (revenues should exceed expenses for an accounting period). When a profit is generated, owners' equity is increased, because revenue and expense accounts are "closed" into the owners' equity account (if the business is unincorporated) or into a retained earnings account (if business is incorporated). Therefore, revenue and expense accounts are really temporary owners' equity accounts.

2.5.1 Impact of Revenue and Expenses

The sale of goods and/or services to guests generally increases an asset (cash or accounts receivable) and also increases a sales account. Expenses are incurred by the restaurant to provide the goods and/or services. The cost of the expenses generally results in a decrease in assets and an increase in expenses. For example, if steaks are withdrawn from the refrigerator for preparation and sales, an asset account (inventory) is decreased and an expense account (food cost) is increased. Note: Sales and expense transactions do not need to involve cash directly. For example, food may be sold to a guest on account, and the food sold may be taken from inventory. A sale on account results in a debit to accounts receivable and a credit to food sales (both are increased). The food sold results in a debit to one account (cost of food sold) and a credit to an asset account (food inventory). When the guest pays the bill, the cash received will reduce the accounts receivable. The entry will be a debit to cash (to increase it) and a credit to accounts receivable (to decrease it). The food inventory was purchased either on account or for cash. If purchased for cash, then the entry debiting the food inventory (to increase its value) and crediting cash (to decrease its balance) was already recorded when the food was purchased. If the food inventory was purchased on account, then the entry at the time of purchase was a debit to the food inventory account (to increase it) and a credit to accounts payable (to increase it). In this case, when the accounts payable is paid, cash will be reduced. The entry would be to debit accounts payable (to decrease it) and credit cash (to decrease it)

2.5.2 Accruals and Adjustments to Income

In many restaurants, hundreds or even thousands of sales and expense transactions occur daily. However, even so, by the end of the accounting period, not all expenses will have been properly recorded. (In other words, sales that have been recorded less expenses that have been recorded will still not be an accurate measurement of income.) Accounting accruals and adjustments must be recorded to properly measure income according to Generally Accepted Accounting Principles (GAAPs). The major principle on which these adjustments are based is matching. This GAAP states that expenses for the period must be matched to the revenue generated by incurring the expenses.

These accruals and adjustments can recognize, for example:

- Incurred rent expense when the rental payment was initially recorded as prepaid rent;
- cost of goods sold when food product purchases have been recorded in an inventory account and not expensed when sold;
- asset depreciation;
- accrued expenses such as payroll, interest, and utilities; and
- actual insurance expense when the initial payment for insurance was recorded as prepaid.

After the recognition of expenses based on accruals and adjustments, income for the period is determined. At the end of an accounting period, several adjusting entries are necessary to match expenses with revenues for the period. The exact adjusting entries depend on the restaurant's accounting practices. Our discussion of adjustments will cover four representative types:

- Inventory/cost of goods sold
- prepaids
- depreciation
- accruals

Inventory/Cost of Goods Sold

Food and beverages are purchased in large quantities so the restaurant can meet heavy demand; reduce the number of times that orders are placed, and sometimes, take advantage of discounts. The result is that a sizable inventory of food and beverage items will be on hand at the end of the period. These items must be physically counted and priced so inventory value can be costed. The result is an end-of-the-period inventory used to determine the restaurant's cost of food sold for the period. In simplest terms, cost of goods sold is determined as follows:

  Beginning inventory
\+ Purchases
– Ending inventory
= Cost of goods sold

Assume a restaurant starts the month with $2,000 of food inventory, purchases $12,000 worth of food items, and ends the month with $2,500 of food inventory. The cost of food sold would be $11,500, determined as follows:

	Beginning food inventory	$ 2,000
+	Purchases	12,000
	Total food available	$14,000
–	Ending food inventory	2,500
=	Cost of food sold	$11,500

Many restaurant managers record food purchased during the month as "purchases" or as "cost of food sold" in a method called periodic inventory. In either case, an adjusting entry is required to accurately recognize the cost of food sold during the month. The adjustment reflects the difference between the value of ending inventory and the value of beginning inventory. If ending inventory exceeds beginning inventory, then the adjustment will reduce the cost of food sold and increase the food inventory. Using the above example (beginning inventory = $2,000; ending inventory = $2,500), the ending inventory is $500 larger than the beginning inventory, so the adjustment follows:

Food inventory	$500
Cost of food sold	$500

If, on the other hand, the ending inventory were less than the beginning inventory, the reverse would be true; an adjustment would be made to increase cost of food sold and decrease the inventory account.

Prepaids

Restaurants may purchase insurance coverage for an extended period or pay rent in advance and then debit a prepaid expense (asset account). Then, over the period of time benefited, the restaurant recognizes the expense by making periodic adjustments. For example, assume a restaurant manager bought a two-year fire insurance premium for $4,800 and recorded the entire amount as prepaid expense. At the end of each month thereafter during the two year period an adjustment of $200 ($4,800 ÷ 24 months) is required as follows:

Insurance expense	$200
Prepaid insurance	$200

This adjustment increases the insurance expense by $200 per month and reduces the prepaid insurance account by $200 per month. At the end of any month, the remaining prepaid insurance is easily calculated: the number of remaining months of insurance coverage (times) the monthly adjustment of $200.

Other expenditures that restaurant managers may record as prepaid and expense over time or with use include rent and office and cleaning supplies.

Depreciation

Fixed assets such as equipment are purchased by restaurant managers to produce the goods and services needed for guests. These assets will benefit the restaurant for several years, yet as the fixed assets are used, they are slowly consumed in a process called depreciation.

There are several different methods of depreciation available that, when followed consistently, can provide a reasonable estimate of cost of a fixed asset used during a specific amount of time.

The best known depreciation method is called the straight-line method (SL). With this method, the same amount is depreciated each period. The formula for the SL method is:

$$\text{Annual depreciation} = \frac{\text{Cost} - \text{Salvage value}}{\text{Life (useful years)}}$$

The cost of the fixed asset refers to the original cost to the restaurant. Salvage value is the estimated value of what the fixed asset can be sold for at the end of its useful life. The useful life refers to the number of years the fixed asset should benefit the restaurant. The first element of the formula (the cost) is known; the second and third factors are based on estimates. However, an experienced manager working with experienced accountants can reasonably estimate the salvage value and expected useful life of the restaurant's fixed assets.

Assume that a dishwashing machine cost $5,500 and is estimated to have a five-year life and salvage value of $500.

The annual depreciation would be $1,000, determined as follows:

$$\text{Annual depreciation} = \frac{\$5{,}500 - \$500}{5} = \$1{,}000$$

To record the depreciation adjustment, depreciation expense is debited, and accumulated depreciation is credited. An accumulated depreciation account may be established for each group of fixed assets, such as equipment or buildings. The accumulated depreciation account is a contra-asset account; its normal balance is a credit.

Other common depreciation methods are sum-of-the-years digits and declining balance. Both of these methods result in greater amounts of depreciation in the early years of the life of the fixed asset. For this reason they are commonly referred to as accelerated depreciation methods.

Accruals

Accrual transactions affect expense and liability accounts. Let's look at two examples.

Payroll accruals

Most restaurant managers pay employees on a weekly or biweekly (every two weeks) basis. As a result, at the end of an accounting period (such as a month), the employees may have worked a few days for which they have not been paid. The GAAP of matching requires that unpaid wages be calculated and recorded during the period in which the incurred expense resulted in revenue. The adjustment is a debit to wages expense and a credit to the liability account, "accrued payroll." Related payroll expenses such as FICA and unemployment taxes should also be accrued.

Example, a manager paid employees on July 29 for work through July 27. The current pay period ends on August 10; therefore, the accrued payroll for four days (July 28–31) must be calculated and recorded for the present accounting period. Using payroll records for hourly workers and the appropriate wage rates, the accrued payroll is calculated at $1,520. This accrual is recorded as follows:

Wages expense	$1,520
Accrued payroll	$1,520

Compensation paid to salaried employees would be recorded as "salaries" expense. For example, if $1,000 of salaries earned during July had not been paid at the end of the month, the transaction would be:

Salary expense	$1,000

Accrued payroll $1,000

Interest accruals

For a second example, consider the accrual of interest. Generally, notes signed by restaurant managers require periodic interest payments in addition to paying part or the entire principal (amount) of the note. However, at the end of an accounting period, the interest may not have been paid through the last day of the period. Therefore, the GAAP of matching requires that the interest be accrued. The formula for calculating interest is as follows:

Interest = Principal × Rate × Time

"Principal" is the amount of the unpaid loan. "Rate" refers to the interest rate expressed on an annual basis; "time" generally is shown as the number of days over which interest is to be calculated divided by the number of days in one year.

The adjustment to record accrued interest is a debit to interest expense and a credit to accrued interest (a liability account). Assume a restaurant owner borrowed $50,000 at 12% interest. The note indicates that interest is to be paid on March 15 and September 15 of each year. The interest that should be accrued for a 31-day month is $509.59:

$$\text{Interest expense} = \frac{\$50{,}000 \times 0.12 \times 31}{365} = \$509.59$$

If the restaurant had already paid $5,000 of principal, then the interest for a 31-day month would be $458.63:

$$\text{Interest expense} = \frac{(\$50{,}000 - \$5{,}000) \times 0.12 \times 31}{365} = \$458.63$$

The adjustment to record the interest expense is as follows:

Interest expense $458.63

Accrued interest $458.63

2.6 THE ACCOUNTING CYCLE

We have covered transactions, the recording of transactions, accounts, trial balances, financial statements, adjustments, and closing entries. Now, the cycle that encompasses all these accounting techniques will be discussed. The accounting cycle occurs every accounting period. A brief discussion of each of the steps in the accounting cycle follows.

Journalizing

Journalizing is the accounting procedure of recording transactions in a journal. In the journalizing process, the transaction is analyzed and classified. Analyzing determines what type of transaction is to be recorded and the amounts that are involved. Classifying involves determining which accounts are affected. Recording is simply writing, processing, or in some other way entering information in a journal (a book of original entry). The most simple and common journal is the general journal. All adjustments and closing entries are recorded in the general journal.

Posting

Posting is the "recording" of debits and credits from journals to the proper accounts. A group of accounts is called a ledger, so often accountants will call an account a "ledger account." The most common and comprehensive ledger is the general ledger. The general ledger consists of accounts for all assets, liabilities, owners' equity, revenues, and expenses. In most handwritten general ledgers, an account appears as in Figure 1.

Account: ________________

Date	Explanation	Folio	Debit	Credit	Balance

Figure 1. General ledger account.

The "explanation" column of the account is for notations that may be helpful to the bookkeeper later. The "folio" column indicates the source of the posting. This will generally be the initials and page number of a journal.

For example, assume that on January 1, a restaurant receives cash of $100 from guests, which is recorded on page 1 of the **cash receipts journal (CRJ).** Assume the cash shown in the cash account prior to this transaction was $1,000. The transaction would be posted to the cash account as shown in Figure 2. The "balance" column is assumed to reflect normal balances for the account (in other words, assets have debit balances, etc.). If the balance for an asset account is a credit, then the credit balance is indicated by bracketing the total. For example, a negative cash balance of $100.00 would be shown as "(100.00)." Two alternative ways to indicate a balance opposite that normally expected would be to write the amount in red or circle the amount.

The account number for cash in Figure 2. is 1001. Restaurants generally assign ranges of account numbers to identify accounts. For example, a restaurant may assign account numbers 1001–1999 for asset accounts, 2000–2499 for liability accounts, etc. The major purpose is to simplify the posting process. When an amount is posted to an account, the account number rather than the account title is written in the journal. Each restaurant will use a different numbering system, depending on its needs.

Keyword

Cash receipts journal is a specialized accounting journal and it is referred to as the main entry book used in an accounting system to keep track of the sales of items when cash is received, by crediting sales and debiting cash and transactions related to receipts.

CASH **Acct. # 1001**

Date		Explanation	Folio	Debit		Credit		Balance	
Jan	*1*	*Balance beginning of period*						*1,000*	*00*
	1	*Received from customers*	*CRJ-1*	*100*	*00*			*1,100*	*00*

Figure 2. General ledger transaction.

Preparing a Trial Balance

Trial balances are prepared to prove that debit and credit balances are equal. This proof is usually conducted just prior to recording adjusting entries. If the debit and credit balance accounts are not equal, the reason must be determined, and the accounts in error must be corrected before making adjusting entries.

Adjustments

The fourth step in the accounting cycle involves determining and recording the appropriate adjustments (adjusting entries) at the end of the accounting period.

Generally, adjusting entries are prepared for:

(a) inventory accounts,
(b) prepaid expense accounts,
(c) recording depreciation, and
(d) recording accruals.

Adjusting entries such as depreciation recorded at the end of every accounting period are often called standard journal entries. After the adjusting entries are recorded in the general journal, they must be posted to the general ledger accounts.

Preparing an Adjusted Trial Balance

As a check that adjusting entries have been properly posted, an adjusted trial balance is prepared. The process is the same as preparing a trial balance except that it follows the recording and posting of the adjusting entries.

Preparation of Financial Statements

The balance sheet and income statement may be prepared directly from either the adjusted trial balance or from the general ledger accounts. Other financial statements such as those involving cash flow and retained earnings may also be prepared at this time. (The information for these two statements does not come directly from account balances; it is taken from the details of both the accounts and specialized journals.)

Closing Temporary Proprietorship Accounts

This step in the accounting cycle includes recording and posting the closing entries. Revenue, expense, and withdrawal accounts (single owner) are closed with closing entries. The closing entries result clear these accounts so that operating results and withdrawals of the following period can be recorded.

Post-closing Trial Balance

This final step, like the trial balances done earlier, tests the equality of debit and credit balance accounts. It consists only of asset, liability, and permanent owners' equity accounts, since all temporary owners' equity accounts have been closed at this point. If debit and credit balance accounts are equal, the accounting cycle is complete.

2.7 SPECIALIZED JOURNALS

To this point, only the general journal has been discussed. It is simple and will accommodate any transaction; however, every entry recorded in the general journal must be posted separately to general ledger accounts. To achieve efficiency in accounting, specialized journals are used. These journals have columns for frequently used accounts so that account titles are not written each time a routine transaction occurs. The column total, rather than each entry, is posted to the appropriate general ledger account.

Specialized journals permit several bookkeepers to take part in the recording process—each handling a different journal. For example, a specialized journal for recording cash receipts will have a cash column. Rather than post each cash entry to the cash account, the total of all cash entries is posted.

The following discussion illustrates the use of specialized journals. Varied formats are used by restaurants in practice, and the specialized journals presented will not correspond with those of any particular business. However, the general functions discussed are performed in accounting systems of almost all restaurants.

Keyword

Cash receipt is a printed acknowledgement of the amount of cash received during a transaction involving the transfer of cash or cash equivalent.

Cash Receipts Journal

One common specialized journal records all transactions involving cash receipts. One column is used for cash; other columns relate to common reasons for **cash receipts**. (Most commonly these are cash sales, collection of notes, and accounts receivable.) An account title must be supplied for each entry in the "other" column, and a folio column is provided for indicating that each amount in the "other" column has been posted to the proper general ledger account.

Note in each case cash is shown as received, and there is an equal amount of credits. At the end of the accounting period, the journal columns are totaled and cross-footed; that is, the totals of the credit columns must equal the total of the debit columns.

The totals of the cash, accounts receivable, and sales columns are posted to the proper general ledger accounts. Each entry in the "other" column is posted individually. In restaurants serving alcoholic beverages it is desirable to separate food and beverage sales by establishing separate columns for food sales and beverage sales. If sales tax is charged, a sales tax column should be included.

Sales Journal Another specialized journal is the sales journal. Typically, it has columns for accounts receivable and sales, as shown in Figure 3. Restaurants that account for sales of food and beverages separately, need separate columns for each. If applicable, a sales tax column is also included. At the end of the accounting period, the columns are totaled, and the journal is cross-footed. After the proof that debits equal credits, the column totals are posted to the proper accounts.

Date		Customer	Accounts Receivable–Debit		Sales–Credit	
Jan	1	R. Rhoads	18	00	18	00
	1	J. Adams	22	00	22	00
	1	M. Gordon	34	00	34	00

Figure 3. Sales journal.

Cash Disbursements Journal

The cash disbursements journal is a specialized journal for recording all disbursements except for payroll. This journal has separate columns for cash and accounts payable. In addition, there is a column titled "other" for accounts less frequently affected.

At the end of the accounting period, the columns are totaled and cross-footed. The totals of the accounts payable and cash columns are posted to the respective accounts. Each entry in the "other" column is posted separately. Most restaurants establish columns for frequently debited accounts.

Purchases Journal

Another common specialized journal is called the purchases journal. Only purchases on account are recorded here. Generally, individual columns are established for food purchases and accounts payable. Columns should be established for other accounts that are frequently charged. Also, an "other" column is included for accounts that are infrequently charged.

CASE STUDY

IMPROVING THE RESTAURANT PRODUCT SALE: A CASE STUDY AT A HOTEL IN SURABAYA

Basically, almost all hotels have the same facilities although in different forms. Hotel A has swimming pools, so does hotel B. Hotel C has a restaurant, so does Hotel D. The element of one hotel which differs from another is the service quality. In its development, there is an intense competition which leads to the condition in which the hotels with the same class have almost the same service standards. Therefore, a hotel management needs to keep achieving the quality of products and service better than its competitors. A hotel should pay attention not only to product orientation but also to market orientation, intellectual capital, and learning orientation so that it can create an innovation.

In general, most of the hotel's revenues come from Room Revenue and Food and Beverages Revenue. Surabaya Plaza Hotel (SPH), for instance, is a fourstar hotel which has strategic location near the shopping centers. This location benefits the hotel, because by having a good location it can attract many guests to come and stay. On the other hand, it appears that having location near the shopping centers, it can be less profitable, especially in food and beverage selling.

In such a situation, SPH is being encountered with a problem. In fact, there are many guests staying at the hotel but they prefer eating at the shopping centers because of their cheaper prices and more variations of foods. Besides that, they can go out for sightseeing or plan to purchase something at the shopping centers. This encourages SPH management to innovate by creating a food product in which most of the consumers either those who stay at the hotel or those who do not are fond of the food product so that it can also popularize the hotel's restaurant.

To solve the problem, SPH innovates by selling Nasi Goreng Jancuk (Nasgorcuk), in order that the staying guests will eat at the hotel. Even there are more people who do not stay at the hotel who come and enjoy Nasgorcuk. It is to the attractive and unique name of this food. It can be proved by the fact that more and more people come to enjoy Nasgorcuk day by day and there are some hotels and restaurants in Surabaya attempt to copycat Nasgorcuk but it is served in different names. As stated by Morrish being proactive in both market driving and being market driven based on market sensing enable entrepreneurial marketing firms to achieve higher performance.

Empirical Studies

Marketing

Marketing is commonly defined as a way done by a company in influencing consumers to purchase the company's products. However, the real meaning of marketing is much wider than just the activities of selling goods and services. As stated by Kotler and Amstrong marketing is the process by which companies create value for customers and build strong customer relationships in order to capture value from customer in return. In this case, Kotler and Amstrong emphasize on creating the value and building a strong relationship with the customers. American Marketing Association in Gundlach and Wilkie defines marketing is the activity, set of institutions, and processes for creating, communicating, delivering, and exchanging offerings that have value for customers, clients, partners, and society at large. Meanwhile, Jobber stated that the modern marketing concept can be expressed as the achievement of corporate goals through meeting and exceeding customer needs better than the competition.

Based on the above definitions, marketing can be described as a series of business activities which aims to plan, distribute, and promote a product or service. Goods or service which is traded should be beneficial for both the seller and the purchaser. Therefore, the sale of goods and service should be well managed. This is in line with what is stated by Anshori, that a market- oriented company should be able to see the needs of their market (i.e. the customers) in the future.

The decision made by the consumer in purchasing a product always becomes a reference for marketing managers in deciding the strategies for attracting the consumers to purchase. It is evident that consumers' behavior in purchasing a certain product must be based on certain aspects related to the consumers' satisfaction. In this case, Anshori and Langne stated that customer satisfaction is critical component of profitability. Exceptional customer service results in greater customer retention which, in turn, results in higher profitability. The higher the satisfactions level of a consumer, the greater his/her to repurchase and inform other people about the positive side of the product.

For that reason, marketers are always trying to fulfill consumer's demands in order to fits the product to consumer's taste and desire. Through marketing mixture, the marketers always try to find new strategies in gaining consumers as many as possible and satisfying them. Principally, customer satisfaction is as important as blood flowing in the vein which maintains the existence and development of the company. Peter and Olson stated that consumer behavior is dynamic because the thinking, feeling, and action of individual consumers, targeted consumer groups, and society at large are consistently changing. Specifically, most of Indonesian consumers' behaviors in purchasing a product are still influenced by price, as stated by Wangso. This phenomenon of price cutting within the context of market in Indonesia has been very relevant to the macro problems such as purchasing power and prestige seeking customer.

Selling Attributes Affecting Consumer

Purchasing transaction commonly involves two or more sides in purchasing process of goods and service. According to Kotler, there are five roles of consumer in making trade decision such as initiator, influencer, decider, buyer, and user.

To explain the connection among these roles, it is important to see the role of marketing mix which influences the consumer's desire to purchase a product. Nasi goreng (fried rice) is a common product which is also sold by many food stalls and restaurants in every corner of Surabaya. If the management does not comprehend the role of marketing mixture, it will be the same as selling a product without certain targets which results in financial loss for the company. To win the competition, a consumer-oriented marketing concept is needed. The concept is based on the marketing activities done by a company that should start from an attempt to recognize and comprehend what consumers need and desire. After that, it is followed by formulating combination of marketing mix as the following.

1. Product

Nasi Goreng Jancuk (Nasgorcuk) is a product made by chefs of Surabaya Plaza Hotel (SPH) which has certain criteria such as: having very hot taste served in large portion (about five times larger than standard portion), and made with four-star hotel standard ingredients in hygienic process. The structure of the product distinguishes Nasgorcuk from the other same nasi goreng (fried rice) in Indonesia. This is in relation to the statement by Holey et al. that a new product should have significant and special qualities compared to other products.

The guests of SPH restaurant prefer nasi goreng for lunch and dinner with much larger portion compared to the other nasi goreng sold in food stalls and shopping centers around the hotel with their timeless customers. This motivates the researcher to investigate how far consideration is made by the consumers in purchasing their favorite food if the location has different ambience from places they usually visit so far. The target consumers of Nasgorcuk are youths and young executives, either that who usually or rarely eat in hotel restaurant. According to Tsai consumers perceive their positive relationships with the service brand not merely on the basis of economic transactions. Social exchanges, interpersonal contacts and symbolic meaning to a considerable extent account for building the kind of consumer-brand relationships that foster strong and durable brand loyalty.

2. Price

According to Kotler and Amstrong price is the amount of money paid for a product or service. In this case, price is one of the factors which make a consumer reluctant to have a lunch or dinner at a hotel restaurant. Generally, price consideration is the main reason preventing someone to come to a hotel restaurant, especially those who come from lower middle class people. In addition, price is the primary consideration of someone from lower middle class in deciding to purchase a product, especially fast food products. A plate of nasi goreng sold in food stalls must be much cheaper than in a restaurant of four stars hotel. Price is probably not a problem for a group of people who are financially established. However a vast market segmentation of food product is a great opportunity for hotel restaurant which can be optimized by adjusting to the price of food they sell. The price of Nasgorcuk is Rp. 99.500,- per portion, and it can be enjoyed by five persons because of its jumbo size. If we divide the price by five, each person will pay Rp. 20.000,-. It is a cheap price for eating at a four stars hotel restaurant.

3. Place

Besides price, place is also a reference for consumer in deciding place where they eat. Places like a hotel have elegant and formal impression because of the image of hotel itself. So far, hotel has an impression as if it is designated for upper middle class because of their financial ability and those who come from lower middle class have “no right” to come to the hotel. On the contrary, they are also able to purchase a portion of nasi goreng. The place can also improve someone’s prestige. Eating on a sidewalk food stalls seems to be less prestigious than eating the same menu at a hotel restaurant.

4. Eating

Nasgorcuk at a four stars hotel restaurant attracts youths seeking for true-self. Life of teenagers recently is inseparable from gadgets related to social networks; therefore SPH provides a prestigious place to hang out, besides room with AC and Wi-Fi for the consumers. Recently, finding an exclusive place to hang out with internet connection is inexpensive. Teenagers and young executives do not feel comfortable without internet connection through wireless network. For that reason, restaurant managers have to respond these demands quickly in order not to be left by this mushrooming community. Market segmentation is commonly accepted as the strategic tool linking the company to the market and driving market choices and value creating strategies (Juttner, Christopher, and Godsell: 2010).

4. Promotion

Consumption experience stops right after and exchange between marketer and consumer. Therefore, marketer needs to manage customer comprehension continually. A customer positive comprehension about a brand or company after consumption is strengthened by the marketer by managing it (Bhaskara and Hendra: 2006). The creation of perception about a product is not merely a result of consumer's direct experience. A good and interesting way of communication is also needed in creating perception about a product in consumer mind. The perception can be both positive and negative based on the consumer's point of view. There are many communication media which can be used to inform consumer about a product. They are conventional media such as brochure, banner, audiovisual in television, and many more.

In this information era, besides these conventional media, internet based media such as social networks: face book, twitter, Blackberry Messenger, blog, and YouTube can also be used. The spread of information using these media is even faster than conventional media. Ismail and Spinelli stated that building an emotional relationship with their customers, companies will make their customers positively talk about their brands. If this is attained, the number of customers using the brand could probably be increased and in turn the company may report a jump in profits.

The information about SPH's Nasgorcuk is widespread using both conventional media and social networks. To consume a portion of Nasgorcuk involves at least four people. Therefore, if each person updates their location or upload their location, the information will spread to other consumers. Here, the positive role of Word of Finger (WoF) is very important. WoF is a method to spread information using social networks. It has the same principle as word of mouth, yet it uses social networks as main technology. Once a consumer has a negative (bad) impression about a product, a large amount of promotion cost will be useless because the negative perception will be widespread through the network which is untouchable by conventional method.

5. People

The concept of service selling is inseparable from the role of people giving service. Service is invisible product; however its benefit can be felt directly by the consumers. In serving SPH's Nasgorcuk, waiters/waitresses play significant role, because they communicate with the consumers directly. Their ability in explaining, serving, and giving solution to a problem is related to what consumer needs. It is an important factor and can influence consumer's decision to come again or not. Being friendly is important in which, the hotel waiters know well about the product, adept and responsive to what a consumer needs gives positive value to the company. Therefore, complete product knowledge and good service procedure must be given to waiters/

waitresses. According to Han (2008) there is a strong possibility that if the company fails to recognize the new competitions, shifting of the consumer interests, and the social trends or innovative technologies, it will loose its market share.

6. Physical

Evidence Nasgorcuk with its jumbo size which can be consumed by four or more persons each portion becomes a special appeal. A very large portion and high level of heat are two of special qualities of Nasgorcuk. Nasgorcuk which is served on a Wajan (frying pan) becomes a unique serving. In normal situation, when a consumer orders a portion of nasi goreng, it will be served on a plate. The large portion of Nasgorcuk indirectly educates the consumers to bring their friends (minimum four persons) each time they come to eat Nasgorcuk. The more small groups enjoy Nasgorcuk means the more people come and see directly its serving presentation. The unique presentation often becomes object of photograph which is later on uploaded and shared on social networks.

7. Process

The process here refers to production process. The length of production process determines consumer's satisfaction on a product, especially fast food product. Chefs' adaptation to processing the orders of Nasgorcuk is one of the keys to maintain consumers' loyalty. Estimated time needed in processing Nasgorcuk starts from ordering until served to consumers is 15 minutes. Nasgorcuk must be served in fresh condition; therefore, either a portion order or ten portions order the procedure must obey this principle. It means that each order uses fresh ingredients before being processed by the chefs, so that Nasgorcuk is not a ready nasi goreng e.g., it is warmed when order comes. A fast process without lowering taste and quantity standards is a factor which takes part in preserving the existence of Nasgorcuk as favorite food of loyal consumers and potential consumers.

Methods

This research was conducted based on explanatory research design to test the hypothesis. The main objective of this study is to determine the extent of the influence of marketing mix towards sales volume of Nasgorcuk. In the first stages of this research describes the character of the respondent as well was their responses about attributes of marketing mix of Nasgorcuk. This is meant to understand the respondent's standard of acceptance to the marketing mix attributes that has been done by Surabaya Plaza Hotel to boost the sales of Nasgorcuk both positively and negatively.

This research used sample survey method as research method and simple random sampling as sampling technique with a small part of population to get general conclusion. Therefore, the data were primary data taken from 140 consumers of Nasgorcuk. The data collection was done by distributing the questionnaires directly to the consumers by requesting them to answer. Beside, a direct interview with each respondent was also done. Most of the respondents are from the high school until university students. Primary data were obtained through questionnaire and data collected direct by author during the field research. The period of data collection was determined by time series method, which was done on January 2012 until June 2012.

The dependent variable was Nasi Goreng Jancuk (Y) while the independent variables were the policy of price (X1), place (X2), promotion (X3), human resources (X4), and process (X5), and physical evidence (X6). For analysis, a statistical model was used to investigate causal relationship among variables. The multiple-linear regression model is as follows: Y = βo + β1X1 +.B2X2+ β3X3+ β4X4+ β1X5+ β6X6+ε.

Results and Discussion

Characteristics of Respondents

The respondents are from various circles, especially those who like Nasgorcuk. Here's an overview of the respondents who contributed to this research.

Table 1. Respondent by gender

Gender	Sum	Percentage
Male	63	45%
Female	77	55 %

Table 2. Age group of respondents

Age Group	Sum	Percentage
Youth	85	60.71 %
Adolescence	36	25.71 %
Elderly	19	13.58 %

Again, as in Table 2, the youth dominated Nasgorcuk lovers. Young age is a time to start developing social relationships. Most of today's youth are connected with social networking through the internet; this condition speeds up the process of communication and spreading of news when a youth gets some information. When a group of youths feel that eating Nasgorcuk in SPH is very satisfying and it is an exciting place to hang out, then the sooner the other youth groups are connected in sequence to try and feel the same way, too.

Table 3. The Education level of respondents

Educational Level	Sum	Percentage
Student	51	36.43 %
College	70	50 %
Others	19	13.57 %

The school term and high school turned out to be the most widely time for gathering friends and best friends to do activities together, including hanging out while enjoying the food. More than 86% of most lovers of Nasgorcuk is group of those students. It is also influenced by the place where they can chat while enjoying the trendy meals so they can proudly proclaim their presence to other peers.

Table 4. Influential promotion media

Promotion Media	Sum	Percentage
Internet connected based	138	98.57 %
Conventional media	2	1.43 %

It was proven that social media marketing is a very effective and inexpensive media. It was effective because the information quickly spread to a vast network. It was also inexpensive as restaurant manager did not need to pay at all for the promotion. This can be seen from the statistics of Nasgorcuk lovers who responded, nearly 99% of them expressed they come to enjoy Nasgorcuk based on information from friends connected through social networking. Yet, keeping in mind that when it occurs negative words of fingers or negative information on these products via SMS and social networking or blackberry, then in a very short time the credibility of the product will be affected for its sale.

From the results of this research, most lovers of Nasgorcuk are young women who are largely still student S1 (undergraduate student). This can happen because of the recent trend of young people now spend their spare time to gather with friends, to hang out somewhere while surfing the internet or to update the status in social media.

Things that must be met in addition to a convenient place and having air conditioning is that privacy must be protected as well, the continous Internet connection, not to mention the affordable price for students' pocket money. SPH has had its own calculations so that the price of a portion of Nasgrocuk will not reduce all facilities demanded by customers.

Product Description of Nasgorcuk (In accordance with the Promotion)

Research on product of Nasgorcuk referring to its lovers' taste was described by several variables that represent the taste of products, such as taste, appearance, and hygiene. Table 5 clearly describes the perception of the lovers of Nasgorcuk through the assessment of attributes that they see and feel.

Table 5. Description of variable product Nasgorcuk

Attribute	N	Scale	Mean	Std.dev
Good look	140	1 – 5	3.67	0.83
Delicious taste	140	1 – 5	3.80	0.91
Enough garnish	140	1 – 5	3.45	0.97
Good hygiene	140	1 – 5	3.88	0.74

Table 5 describes that on average the respondents are very satisfied with the product of Nasgorcuk, either in terms of appearance, good taste or hygiene of the product of Nasgrocuk, they agreed that it is appropriate for consuming for and fit with existing promotions.

As in Table 6, the price of Nasgorcuk, both package and non-package, (meaning that the package is Nasgorcuk price plus a pitcher of iced tea) is considered to correspon to the ability of students. Similarly, the price of drinks is also considered reasonable when compared with the price of drinks in other places in general. Their costs for enjoying Nasgorcuk, coupled with the facilities of free wifi and a cool and comfortable place, make the very good value for money, in other words the cost is commensurate with the pleasure obtained.

Table 6. Description of price variable

Attribute	N	Scale	Mean	Std.dev
Low price	140	1 – 5	3.39	1.04
Cheap nasgorcuk package	140	1 – 5	3.43	0.98
Cheap drinks	140	1 – 5	3.07	1.18
Value for money	140	1 - 5	3.53	0.99

Table 7. Description of place variable

Attribute	N	Scale	Mean	Std.dev
Nice place	140	1 – 5	3.95	0.83
Compfortable place	140	1 – 5	4.09	0.71
Cheap drinks	140	1 – 5	3.94	0.79
Value for money	140	1 - 5	3.87	0.81

Place variable, as in Table 7, also gets very good score by the respondents, even the comfort and cleanliness as well as a great place are more appreciated, although other variables also have very good values. Of course, this can be done because the restaurant for eating Nasgorcuk is in Surabaya Plaza Hotel, a four-star hotel, which has set the standard for the restaurant as a place worthy of an international place for meal.

Table 8. Description of promotion variable

Attribute	N	Scale	Mean	Std.dev
Newspaper	140	1 – 5	2.82	1.02
Flyer/poster place	140	1 – 5	2.76	0.94
Social Network	140	1 – 5	4.08	0.89
BBM	140	1 - 5	3.12	1.24

A great surprise is the promotion variable, the respondents are now less concerned with conventional promotional tools such as newspapers, radio, brochures and even posters with jumbo size (see Table 8). The score for this way of promotion is very low, even practically not seen at all by the respondents that mostly female youths. adolesce. But, if it is talked via BBM as well as chatting and the like, they are very responsive to new information. It proved that they received information about the existence Nasgorcuk mostly from facebook, twitter, BBM and the like, and they feel this kind of information is quite effective and believeable because that information is not from the producer, but from his own close friends and relatives so that they have faith in it which is an absolute truth for them.

Table 9. Description of human resource variables (people)

Attribute	N	Scale	Mean	Std.dev
Skillful Waiter	140	1 – 5	3.64	0.91
Good Waiter	140	1 – 5	3.77	0.81
Smart Waiter	140	1 – 5	3.60	0.87
Good Grooming	140	1 - 5	3.69	0.86

The waitress (waiter / ress) is a variable that gets pretty good score from the respondents (see Table 9). They are considered skillful, adept and understand the needs of consumers, of course coupled with an excellent appearance. This is understandable because they are employees of the hotel. They are trained for it as a waiter / waitress of star hotel restaurant, where they are used to meeting guests of the middle class and above. Therefore, the interface and the serving already fulfill the qualification for star rated hotel. Moreover, SPH management also applies standard service for anyone who enjoys a meal in the restaurant, including the consumer of Nasgorcuk lovers.

Table 10. Description of process variable

Attribute	N	Scale	Mean	Std.dev
Easy reservation	140	1 – 5	3.81	0.87
Quick ordering	140	1 – 5	3.48	0.92
Available place	140	1 – 5	3.75	0.78
Easy	140	1 - 5	3.80	0.76

The variables of Nasgorcuk making process are considered pretty well by the respondents (see Table 10). This means that ordering is considered very easy, no long waiting times and places, or always available when they come. Payment transactions are also considered to be very easy and efficient. The process becomes very important when time is too long to wait, but in this case it would be very different for Nasgorcuk concerning the description of the time. When consumers are on their own, ordering a particular food within 15 minutes will be so long. But, for the buyers of Nasgorcuk never comes alone, so 15 minutes is considered fast, because they enjoy themselves before the meal come and chat in a cozy space while still on-line at each gadget.

Table 11. Description of Physical Evidence variables

Attribute	N	Scale	Mean	Std.dev
Very hot taste	140	1 – 5	4.31	0.95
Large portion	140	1 – 5	4.33	0.87
Fresh serving	140	1 – 5	4.12	0.80
Good rice quality	140	1 - 5	4.18	0.87

Variable of physical appearance of Nasgorcuk was responded so well by the respondents. As in Table 11, the high level of very hot taste is in accordance with the promotion, as well as a considerable portion, even it can be wrapped to take home. What is also very important is the quality of materials and ways of serving food, fresh from the kitchen. The quality of materials and how the serving is required to comply with the standard of star rated hotel. Although the products served are food products that can be found in any food stall, the production process until the serving is considered as the star hotel class. This really distinguishes physically Nasgorcuk with other fried rice.

Analysis of the Effect of Marketing

Mix on Nasgorcuk product To see the effect of the marketing mix on increasing sales of Nasgorcuk, this study used multiple regression analysis. However, prior to analysis, prior assumptions must be tested, also both the validity and reliability of data, as well as normality and other tests that were essential in order to apply full regression analysis. The analysis can be seen in Table 12.

Table 12. Model summary

Model	R	R Squre	AdjustedR Square	Std. Error of the Estimate
1	0.638	0.407	0.380	0.50849

From Table 12, it can be noted that the research model of Nasgorcuk gives enough effect to the product which is seen from the R^2 of 40.7%, while the remaining 59.3 percent are caused by other factors which are not included in the study variables, but can affect the existence Nasgorcuk.

Table 13. Analysis of variance

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	23.078	6	3.846	14.876	0.000
Residual	33.614	134	0.259		
Total	56.692	140			

From Table 13, it can be explained that regression model of relationship built can be explained very well; it is known from α which is higher than significant figures. Therefore, dependent variables can explain the independent variable.

Table 14. Data regression model

Model	Unstandardized Coefficients B	Std. Error	Standardized Coefficient Beta	t	Sig.
(Constan)	.831	.330		2.521	.013
X1	.188	.054	.262	3.499	.001
X2	.267	.073	.275	3.643	.000
X6	.279	0.64	.311	4.335	.000

In Table 14, it is found the regression equation, Y = 0.831 + 0.188X1 0.267X2 + 0.279X6. The regression equation indicates that the variables of price, place and Phisichal Evidence have positive significant effect on product enhancements of Nasgorcuk. While the other variables in this study such as promotion, human resource and process do not significantly influence the increase Nasgorcuk product, it is expressed with α greater than significance figure.

Managerial Implications

In order to sustain and keep Nasgorcuk lovers continue to grow then there are some factors that should be considered, including: First, the consistency of the look and taste, a standard look and taste that is a trademark of Nasgrocuk should always be maintained. It is very important because most respondents will immediately inform Nasgorcuk through on-line in a chain to a vast social network. If there is little change in consistency of product, it is feared that it will directly impact on product sales. Second, consumers feel the price is quite affordable for a given class of hotel, because to raise prices should need calculations that are the potential reduction in the number of diners.

Consumer confidence in the product Nasgrocuk is necessarily not in branding through conventional information media, both print and audio visual. Consumers today are very savvy and rely more on word of fingers (convey information via Blackberry or Mobile) obtained from colleagues, friends and relatives via the internet based on social networking. Third, Nasgrocuk lovers are the youths who love and desire for changing the trend such as a gathering place and dining. It's important to facilitate their activities so they feel comfortable. Such facilities include: not a low connection for free wifi, power plug (socket) to Mobile (HP) and Blackberry (BB) charger even if there needs to be mobile charger station from various brands of HP and BB, HP pulses sales, back ground music and others.

There needs to product development, especially to display the serving in order to avoid boredom for the consumer. Besides, it can also continue to develop Nasgorcuk related merchandise such as T-Shirt, key chain, etc., which can help the promotion of low cost. Moreover, product differentiation should also be made specifically to accommodate consumers who do not like spicy food.

Conclusion

It can be concluded that to increase the product of Nasgorcuk in Surabaya Plaza Hotel is caused by the physical appearance of a product that is satisfying customers, supported by affordable pricing policy, as well as a prestigious dining and comfortable place. Still there are some attributes that can give a major effect on product enhancements missing in Nasgorcuk research variables. This is due to the focus the researchers has that is on the marketing mix, based on the theory that has been widely used in the science of marketing. The rapid advancement of information enables several new variables in line with current technological advances.

SUMMARY

- Business transactions are events that have a monetary impact on the financial statements of an organization.
- A business transaction is an economic event with a third party that is recorded in an organization's accounting system. Such a transaction must be measurable in money.
- The "things" owned by a restaurant are called assets and commonly include cash, accounts receivable, equipment, land, buildings, food/beverage inventories, and investments.
- Some assets are given to the restaurant by its owners; other assets might be obtained by borrowing money from a bank or other lenders.
- The restaurant's goal is to generate profit. Profit (net income) results when revenues exceed expenses. Revenues increase owners' equity; expenses reduce owners' equity.
- All transactions affect the basic accounting equation and are recorded in accounts. An account is a device for recording increases and decreases in a single asset, liability, or owners' equity item.
- Revenue and expense accounts are really temporary owners' equity accounts, because they are closed out each period to the permanent owners' equity accounts.
- Effective accounting for restaurants is one of the most important aspects of making your business successful.
- Like any business, restaurants will have fixed and fluctuating expenses. Fixed expenses are often cost of operations, including rent, utilities, insurance, loan payments, and salaried employees are all fixed expenses.
- Choose accounting software to streamline your data entry tasks, create customized invoices, track your revenue, create regular profit and loss statements and review your cash flow.
- Prime cost is a summation of all your labor costs and your cost of goods sold. Paying your restaurant staff, including front-of-office staff and kitchen crew, are part of your labor costs. It also includes benefits, payroll taxes, etc.
- Debit simply is an entry on the left side of an account, while credit is simply an entry on the right side of an account.
- All transactions are recorded with at least one debit and one credit entry, and in all cases, the total of debits must equal the total of credits for an entry.

- A trial balance is a listing of all accounts with their debit and credit balances. A trial balance is prepared at the end of an accounting period and is the first step in developing financial statements.
- Many restaurant managers record food purchased during the month as “purchases” or as “cost of food sold” in a method called periodic inventory.
- Fixed assets such as equipment are purchased by restaurant managers to produce the goods and services needed for guests.
- Journalizing is the accounting procedure of recording transactions in a journal. In the journalizing process, the transaction is analyzed and classified.

MULTIPLE CHOICE QUESTIONS

1. **Which one of the following is a record of financial transactions taking place between a guest and the hotel?**
   a. Folios
   b. ledgers
   c. Guest accounts
   d. Vouchers
2. **The critical part of accepting payment is:**
   a. bill accuracy
   b. collecting payment
   c. getting it to the register and recording it
   d. making sure the guest gets a receipt
3. **When a credit or debit card is declined it is important to always:**
   a. destroy the card
   b. treat the customer with respect
   c. assume the card is stolen
   d. make sure you have other payment before you return the card to the guest
4. **When processing credit card payments, the staff should be trained to:**
   a. automatically add a tip to the transaction
   b. give the card to the manager for verification
   c. return the card to the person you presented the check to regardless of the actual owner
   d. verify that the signature on the receipt matches the signature on the card
5. **Making sure proper payment is collected and gets back to the restaurant is an issue with:**
   a. dine in customers
   b. carry out orders
   c. delivery orders
   d. parties of eight or more

Review Questions

1. What do you understand by business transactions? Describe.
2. How the revenue and expenses impact owners' equity? Explain.

3. Describe the types of restaurant expenses.
4. How to do bookkeeping for a restaurant.
5. Write short notes on:
    - Account balances
    - Trial balance
    - Specialized journals

Answer to Multiple Choice Questions

1. (a) 2. (c) 3. (b) 4. (d) 5. (c)

REFERENCES

1. Andreas I. Nicolaou. “A Contingency Model of Perceived Effectiveness in Accounting Information Systems: Organizational Coordination and Control Effects”. International Journal of Accounting Information Systems, 2000, 91-105.
2. Anil Keimer (2008), “Uses of Accounting and Limitation of Financial Accounting”, Gupta Platinum Ezine Articles.
3. Dopson, L.R. (2008). Food and beverage cost control (4th ed.). Hoboken, NJ: John Wiley & Sons, Inc.
4. Feinstein, A.H., .£ Stefanelli, J.M. (2002). Purchasing: Selection andprocurementfor the hospitality industry (5th ed.). New York: John Wiley & Sons, Inc.
5. Gisslen, W. (2007). Professional cooking (6th ed.). Hoboken, NJ: John Wiley & Sons, Inc.
6. Harbaugh, R. (2002), “Proven lessons for generating good mail survey response rates”, Medical Marketing and Media, Vol. 37 No. 10, pp. 70-5.
7. Harendra Kariyawasam. 2017. “The Use of Accounting Information System as a tool in Strategic Decision Making: Evidence from the Sri Lankan Accommodation Industry” International Journal of Scientific Research and Innovative Technology ISSN: 2313-3759 Vol. 4 No. 10
8. Jagels, M. (2007). Hospitality management accounting (9th ed.). Hoboken, NJ: John Wiley & Sons, Inc.
9. Keiser, J., & DeMicco, F. (with Grimes, R.) (2000). Contemporary management theory: Controlling and analyzing costs in foodservice operations (4th ed.). Upper Saddle River, NJ: Prentice-Hall, In
10. Labensky, S.R., & Hause, A.M. (2003). On cooking: A textbook ofculinaryfundamentals (3rd ed.). Upper Saddle River, NJ: Prentice-Hall, Inc.
11. Larson, P.D. and Chow, G. (2003), “Total cost/response rate trade-offs in mail survey research: impact of follow-up mailings and monetary incentives”, Industrial Marketing Management, Vol. 32 No. 7, p. 533.
12. Miller, lE., Dopson, L.R., & Hayes, D.K. (2005). Food and beverage cost control (3rd ed.). Hoboken, NJ: John Wiley & Sons, Inc.
13. National Restaurant Association, Deloitte & Touche LLP (2006). Restaurant industry operations report (2006/2007 ed.). Chicago, IL: National Restaurant Association
14. Nedlees B., H. Anderson, J. Caldwell, 2000, « The Basic Principles of Accounting ». Edition V - a / Translation from English. - Chisinau : ARC, p. 4

CHAPTER 3

THE BALANCE SHEET

"There are men who can write poetry, and there are men who can read balance sheets. The men who can read balance sheets cannot write."

- Henry R. Luce

INTRODUCTION

A restaurant balance sheet lists out a restaurant's assets, liabilities, and equity at a given point in time. This statement can be used to forecast short and long-term cash flow and assess the overall financial health of the restaurant.

Overall, maintaining a restaurant balance sheet allows you to simultaneously verify the accuracy of a profit and loss statement while getting a more holistic view of the restaurant's financial health.

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

1. Understand your restaurant balance sheet
2. Explain balance sheet format
3. Manage your restaurant balance sheet
4. Know how to read a restaurant balance sheet

A balance sheet shows net worth of the restaurant. You can think of a balance sheet as a set of scales showing Liabilities on one side and Assets on the other. They show the balance, which is where we get the name.

The purpose of the Balance Sheet is to see which way the "scale" is tilted. That is, if you're losing money, making money or breaking even.

Some terms used on a balance sheet are used interchangeably. Keep these terms in mind when learning about balance sheets. Another name for Liabilities is Debt.

An example of debt is a loan. The loan amount will be recorded in the Liabilities column of the balance sheet.

But the result of the loan—a lump sum of cash given to you by the bank — is recorded as an Asset. Equipment with long term value or property purchased by the business is also recorded in the Assets column.

Even if you're still paying them off, those items are your Assets. The remaining amount you owe is a Liability.

In this example, Assets and Liabilities "balance", because debt is roughly equal to your assets.

To complete a Balance Sheet for your restaurant

- List all your *Assets* in one column
- List all your *Liabilities* in another
- Subtract your *Liabilities* from *Assets*

■ What is left over is your restaurant's *Net Worth*

If *Net Worth* is a negative number, that means your restaurant owes more than it's worth. This is what they call "being in the hole", "upside down" or "in the red". Ideally, your assets and liabilities balance. Or even better, assets outweigh debts.

However, when you are starting a new restaurant there will likely be a period where your business owes more. This is why a restaurant startup is risky. It takes a large amount of capital for the business to start generating its own income.

Here is an example of a Restaurant Balance Sheet:

Balance Sheet
Restaurant Name: Good Eats
Date: 03/05/xx

Assets	$	Liabilities	$
Current Assets:		**Current Liabilities:**	
Cash on hand	3000.00	Accounts payable	4,500.00
Cash in the bank	21,000.00	Rent/Lease	3,600.00
Inventory	6,350.00	Utilities	1,500.00
Prepaid expenses	2,200.00	Sales Tax	1,250.00
Accounts Receivable	1,500.00	Income Taxes	2,200.00
Total:	34,050.00	Payroll	14,000.00
Fixed Assets:		Employee Medical Insurance	3,550.00
Real Estate (Land/Building)	-	**Total:**	30,600
Furnishings	5,000.00	**Long Term Liabilities:**	
Kitchen Equipment	250,000	Long-term loans	305,000.00
Other Assets	45,000	Other long-term	-
Total:	300,000.00	**Total:**	305,000.00
Total Assets:	334,050.00	**Total Liabilities:**	335,600.00

In the startup phase, you will be spending a portion of *Assets* on operating costs that are *Expenses*. *Expenses* are services and disposable items that do not retain long term value.

3.1 UNDERSTANDING YOUR RESTAURANT BALANCE SHEET

Your restaurant's balance sheet shows you your net worth in terms of assets and liabilities. You see the 'balance' between income and expenses, which is why it's called a 'balance sheet' in the first place. Restaurateurs wanting to scale their restaurant need to be up to date with their balance sheets.

One basic mathematical formula you need to keep in mind is for your assets. It's the sum of your equity and liabilities.

Assets= Liabilities + Equity

Assets are what your restaurant owns or generates revenues from, like equipment, inventory, cash in hand, etc.

Liabilities are expenses and outstanding bills of your restaurant, including property rent, any loans, or vendor bills.

Keyword

Revenue generation is one of the most important activities any business can engage in. It is defined as a process by which a company plans how to market and sell its products or services, in order to generate income.

Restaurant equity is the division of ownership between you and any partners or investors.

Calculating your balance sheet is a multiple-step process. The first step is to note down all your assets and liabilities in one place. Subtract your liabilities from your assets, and there you have your net worth.

A negative net worth indicates that your restaurant owes more than it earns. What you need to understand is that the first few months will always be hard for your restaurant. Net worth might constantly be negative. However, with constant growth and positive **revenue generation**, your balance between assets and liabilities will stabilize!

If you have just started to look at your restaurant's accounts, you probably would need to be more familiar with some terms related to your balance sheet. Now, one thing you need to understand here is that the scale of your brand decides the complexity of your balance sheet. In cases of complex calculations, it is always beneficial to use restaurant management software with your spending, earnings, and so on.

Restaurant Name: Bistro De Lux
Profit and Loss Statement
Period: Q3

Costs / Expenses	
Rent / Lease	($6,700.00)
Service on Debts	($18,200.00)
Payroll	($28,000.00)
Taxes and Fees	($24,000.00)
Food Costs	($32,000.00)
Utilities	($7,800.00)
Other Expenses	-
Total Costs	($116,700.00)
Income / Sales	
Food Sales	$255,000.00
Beverage Sales	$87,000.00
Catering	$19,000.00
Events	8,000.00
Delivery Charges	$2,300.00
Other Income	-
Total Sales	$371,300.00
Profit / Loss	$254,600.00

Here's a list of your different assets and liabilities for your restaurant.

Assets:

- Sales
- Salaries
- Employee Benefits
- Occupancy
- Depreciation
- Interest
- Other income

Liabilities:

These can be further divided into two segments based on their term, current responsibilities, and long term liabilities. Another difference between the two is that the long term liabilities are not familiar to all restaurants.

Current Liabilities:

- Short term loans
- Utilities
- Lines of credit
- Income tax deductions
- Medical plan payments
- Property rent
- Equipment
- Employee salaries
- Long term Liabilities:
- Any long term lease
- Deferred revenues
- Capital leases

Equity:

In simple terms, equity is what is left in the business, after tax. It is more commonly known as your referred earnings. It includes common stock, preferred stock, other comprehensive profits, and treasury stock. The shareholders of your restaurant own it.

DID YOU KNOW?

Guidelines for balance sheets of public business entities are given by the International Accounting Standards Board and numerous country-specific organizations/companies. The standard used by companies in the USA adhere to U.S. Generally Accepted Accounting Principles (GAAP).

3.1.1 Restaurant Balance Sheet vs. Restaurant Profit and Loss Statement

The restaurant balance sheet and restaurant profit and loss statement are both valuable tools for evaluating financial performance. However, they both provide different insights.

Here's how:

- **Purpose.** The profit and loss statement shows the amount of profit or loss generated by the restaurant. That is, how sales compared to spending. The balance sheet is intended to show the overall financial situation of the restaurant. This includes all business expenditures, debt, and ownership equity in the business. If you were to invest in a perpetual inventory system like BinWise Pro, the cost and savings would all appear in your balance sheet. This all-in-one solution tracks inventory, cuts costs, par level, and provides real time insight into stock and sales trends.

- **Data.** A profit and loss statement includes data on the restaurant's cost of goods sold, gross profit, and prime cost. This data analyzes the restaurant's performance over a given time period. Things like labor cost can be found here. The balance sheet includes far more data including all assets, debts, and investments in the business. Things like overhead expenses and business loans can be found in the balance sheet.
- **Usage.** The profit and loss statement is intended to highlight sales data and profits or losses. This lets a restaurant know if they need to adjust plans to increase profits. They may then try things like menu engineering using psychological pricing or try bar promotion ideas like new happy hour ideas. The balance sheet provides a higher overview of the business as a whole and helps identify cost savings and opportunities to increase margins.

3.1.2 Purposes of Balance Sheet

The balance sheet, also known as the statement of financial position, reports the assets, liabilities, and net worth of the restaurant at a single point in time (generally month-end). It provides a static snapshot of the restaurant's financial position. If a second balance sheet were prepared for the operation even one day after the end of the accounting period, it would probably reflect a different "picture" of assets, liabilities, and net worth than did its counterpart prepared one day earlier.

Keyword

Cash on hand comes in the form of money that a business has available at a certain time. Further, it is cash that a business has after it has paid all costs. When it comes to balance sheets, it shows that the balance held by a business is in the form of coins and notes.

Financial information from the balance sheet is used by different users for different reasons. It has several important purposes, including the following:

- It tells the amount of cash on hand at the end of an accounting period. All assets are eventually converted, either directly or indirectly, to cash. This process may result in a partial loss (such as uncollected accounts receivable). Alternatively, several months (or even years) may evolve be fore an asset such as a dishwasher is fully used. (It is converted to an expense through a depreciation process.) **Cash on hand** is cash available for alternative future uses such as paying bills and disbursing to owners.
- It explains details about assets. Fixed assets represent a fairly high percentage of the total assets of many restaurants. Several years are required to fully use these assets in the business.
- It reviews the composition of debt and net worth (if a proprietorship) or stockholders' equity (if a corporation). This reflects how the restaurant has been financed. The greater the amount of debt financing with equity, the greater the financial risk. A restaurant that has used debt to finance a large percentage of its fixed assets may have a difficult time securing financing for more debt. It shows the amount of the restaurant's past earnings that have been retained in the business. For a corporation, retained earnings is the sum of past earnings retained in the business. For a sole proprietorship, past earnings are part of the (name of proprietor), Capital. For example, the account for James Smith, the sole owner of a foodservice business,

would simply be James Smith, Capital. Generally, the greater the retention of internally generated funds, the less borrowing will be required during an expansion period.

- The balance sheet provides insight into a restaurant's ability to pay bills; liquidity is important in the timing of cash flows.

The past several years have seen a renewed interest in the balance sheet. Some firms that have consistently reported profits on their income statement have gone bankrupt (or are nearly bankrupt) a short time later because they were unable to pay their bills as they became due. The balance sheet reveals the amount of debt. There are numerous ways to analyze a restaurant's balance sheet. This includes the use of ratios to relate balance sheet items to each other and to assess the relationship between operating (income statement) information and balance sheet items.

3.1.3 Balance Sheet Restaurant Example

To help make restaurant balance sheets a little easier to understand, here's an example of how creating one works.

For this example, we'll be operating a restaurant/bar called JJ's British Pub. First, we need to look at our financial data for our total assets, liabilities, and equity. We'll break those out more below if you don't know what they are.

You can find most of this data by looking at your POS system and accounting software. If you use BinWise Pro, you can pull the most accurate inventory numbers from there for data you can trust.

In our case, we find that we have:

- Total assets: $379,000
- Total liabilities: $193,250
- Total equity: $185,750

Next, we need to make sure these numbers are balanced. We can do that by using the formula below.

Assets = Liabilities + Equity

If the data in your balance sheet is correct, both sides of this formula will be equal. If they aren't, there is an error somewhere in your data and you'll need to work backward to find it.

Let's put in our numbers.

Assets = Liabilities + Equity

$379,000 = $193,250 + $185,750

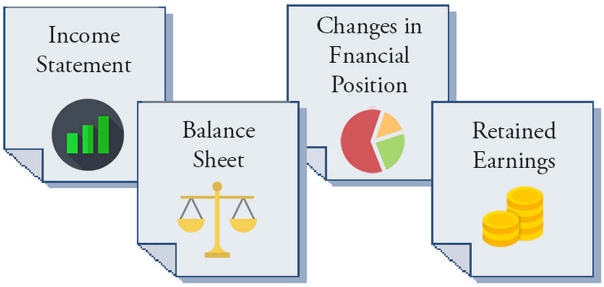
$379,000 = $379,000

Both sides of the equation are equal, so we know the numbers are correct.

Now, we can use that information to determine if we should invest in restaurant marketing, we should cut ingredients to reduce food cost, and more.

3.1.4 Leveraging Your Balance Sheet

A smart restaurant management software gives you real-time updates about your sales, your growth, the purchase orders made, and thereby the changes in your balance sheet. Analyzing your restaurant's financial health now and then helps you make better pricing decisions. You can make early predictions of your sales trends based on consumer behavior.



3.1.5 Takeaways For The Restaurateur

Once you understand how to calculate your balance sheet accurately, make sure that you take care of these two things!

- Never Track Expenses From Multiple Sources: Checking your balance sheet from multiple sources can only create more confusion. Since numerous factors come into the picture while correctly analyzing the balance sheet, you need to trust one source and stick to it. Using your restaurant POS for the same can be your best bet!
- Check Your Reports Daily: A lot of restaurateurs have agreed that timely checks of their accounts lead to the prevention of any malpractices. There have been a lot of times when restaurateurs feel that the restaurant is doing well without checking their balance sheet, and therefore face considerable losses in the later run.

REMEMBER

All in all, your restaurant's balance sheet gives you a clear understanding of your restaurant's financial health. Keeping a regular check on it helps you make better decisions at your restaurant.

3.2 BALANCE SHEET FORMAT

The details of the balance sheet used by restaurants vary based on business size and complexity, the related businesses of the restaurant owners, and the type of organization (sole proprietorship, partnership, or corporation).

Related balance sheet items are normally combined to keep information concise. For example, all cash accounts may be combined and reported as "Cash"; all inventory accounts may be combined and reported as "Inventory." The amount of consolidation depends on, first, the similarity of items (only similar items should be combined), and second, the complexity of items (consolidation should make the balance sheet more understandable). Users' needs, then, should be a major consideration in the preparation of the balance sheet.

When important details about balance sheet items are left off the statement itself, they may be included in supporting schedules. For example, all long-term notes may be shown as one item on the balance sheet if there is a supplementary schedule that lists the notes along with their interest rates and maturity dates.

Another way to enhance the balance sheet presentation is to use notations. For example, the inventory value may be shown as follows:

Inventory for resale (FIFO) $22,300

This disclosure informs the reader about the basis of inventory valuation. The term "FIFO" — first in, first out — means that the inventory value is based upon the latest (most recent) purchase price, because items first purchased are first used. This technique is useful for other items such as marketable securities, accounts receivable, fixed assets, long-term debt and capital stock.

Restaurant Name: ______________		Date: ______________	
Retained earnings at (date—beginning of period)			$XXX
Additions: Net Income		$XXX	
	Other	XXX	XXX
Deductions: Dividends Declared		(XXX)	
	Other	(XXX)	(XXX)
Retained earnings at (date—end of period)			$XXX

Figure 1: Statement of Retained Earnings.

Generally, restaurants provide balance sheets for two periods. This comparative form enables readers to compare two sets of financial information so that trends can be assessed.

3.2.1 Statement of Retained Earnings

Some restaurants provide a separate statement depicting changes in retained earnings rather than including this detail on the balance sheet. This approach results in a more concise balance sheet but does require another statement. The recommended form for this approach is as shown in Figure 1.

3.2.2 Footnotes to the Balance Sheet

Footnotes to balance sheets help to explain their content. Footnotes are meant to clarify, not to replace, content. They can relate to methods of valuation, the existence of contingencies, details of long-term debt, significant accounting policies, and other matters that require explanation to make them more understandable.

3.2.3 Balance Sheet: Uniform System of Accounts

The Uniform System of Accounts for Restaurants (USAR) contains a recommended balance sheet format and provides a dictionary of financial terms for the various balance sheet accounts. Much of the discussion above has been based upon the NRA's Uniform System. Figure 2 shows the USAR balance sheet format.

Balance Sheet Format

Name of Restaurant Company as of (Insert Date)

Current Assets		
Cash on Hand	$ 15,000	$ 40,000
Cash in Banks	25,000	
Accounts Receivable:		
Trade	6,000	
Employees	2,000	
Other		
Total Receivables		
Deduct Allowance for Doubtful	2,000	9,500
Accounts	10,000	
Inventories:	(500)	
Food		
Beverages		

Gift and Sundry Shop	9,500	11,650
Supplies	1,050	6,500
Prepaid Expenses		**67,650**
Total Current Assets	100	
	1,000	
Due from officers, stockholders, partners and employees		1,000
Due from affiliated or associated companies		500
Cash held by trustee—restricted		400
FIXED ASSETS:		
Land	60,000	
Buildings	150,000	
Cost of Improvements in Progress	5,000	
Leasehold and Leasehold Improvements	40,000	169,000
Furniture, Fixtures and Equipment	12,000	
Uniforms, Linens, China, Glass, Silver, Utensils	3,000	
Deduct Accumulated Depreciation and Amortization	(101,000)	
Net Book Value of Fixed Assets		
DEFERRED EXPENSES:		
Organization and Pre-opening Expenses	4,000	
Bond Discount and Loan Initiation Fees	6,000	
		10,000
OTHER ASSETS:		
Amount Paid for Goodwill	5,000	
Cost of Bar License	20,000	
Rental Deposits	8,000	
Cash Surrender Value of Life Insurance	5,000	
Deposit on Franchise or Royalty Contract	25,000	
		63,000
TOTAL ASSETS		$ 311,550

Liabilities and Shareholders' Equity

Current Liabilities

Accounts Payable:		
Trade	$ 145,000	
Others	4,000	$ 149,550
Notes Payable—Banks		15,000
Taxes Collected		4,000
Accrued Expenses:		
Salaries and Wages	5,000	
Payroll Taxes	3,000	
Real Estate and Personal Property Taxes	4,000	
Rent	5,000	
Interest	2,000	
Utilities	1,000	
Other	2,000	22,000
Employees' Deposits		500
Deposits on Banquets		500

Income Taxes—State and Federal		7,000
Current Portion of Long-Term Debt		9,000
Dividends Declared and Payable		5,000
Total Current Liabilities		**212,500**
Due to officers, stockholders, partners		1,000
Due to affiliated or associated companies		2,000
Long-term debt, net of current portion		30,000
Deferred income taxes		9,000
Other noncurrent liabilities		7,000
TOTAL LIABILITIES		**261,550**
SHAREHOLDER'S EQUITY (if a Corporation):		
Capital Stock	5,000	
Description of Each Type of Stock, Shares Authorized and Issued, Stated Value per Share		
Retained Earnings	15,000	
Total Shareholders' Equity		**50,000**
NET WORTH (if an Individual Proprietor or Partnership):		
Proprietor's Account	50,000	
Partner A	25,000	
Partner B	25,000	
Total Net Worth	50,000	
TOTAL LIABILITIES AND CAPITAL		$ 311,500

Figure 2: Uniform Systems of Accounts for Restaurants (USAR).

3.3 MANAGING YOUR RESTAURANT BALANCE SHEET

As a restaurant owner or operator, you know that without monitoring, restaurant expenses can easily grow out of control. Your **financial statements**, such as your restaurant balance sheet and profit and loss statement, are tools to understand your business. Now more than ever, as your business runs in a delivery/takeout/curbside model, and prepares for an anticipated phased-in reopening, records of financial activity, organized by different kinds of financial statements, help you lay the foundation for a strong business and make informed decisions now and in the future.

Keyword

Financial statements are formal records of the financial activities and position of a business, person, or other entity.

3.3.1 Restaurant profit & loss statements

A profit and loss statement, otherwise known as a P&L statement, summarizes the revenue, costs, and expenses of your business over a certain period of time. A P&L statement tracks your restaurant's business performance against expenses, restaurant sales, and Cost of Goods Sold (CoGS).

Your P&L reviews all of your revenue and expenses over a certain time and helps you decide your next steps. A positive P&L means that you can proactively make decisions to become even more profitable, and a negative P&L means you need to alter your business strategy to decrease costs or increase revenue.

Calculating your profit and loss statement

Your Profit & Loss statement tracks detailed information about your sales, CoGS, and expenses, calculating your total profit or loss with the following formula:

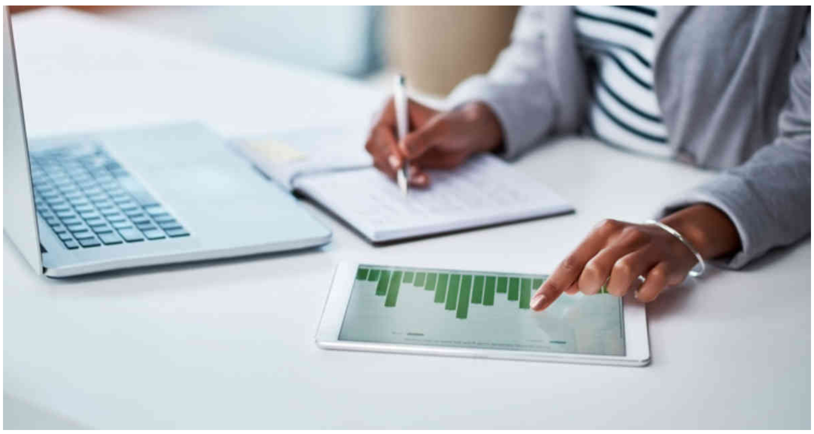
Sales – Cost of Goods Sold – Expenses = Profit or Loss

Your P&L is extremely valuable to manage your operations, budget, and future business growth. By monitoring key metrics, you can compare your business to industry targets or monitor different experiments you may be running. For both single-unit operators or nationwide restaurant groups, your data can help you have context for your future decisions about controlling expenses, menu adjustments, or labor cost controls. Some financial reporting software can even segment your P&L data by location, helping you drill down to identify the strengths and weaknesses within your organization.

The importance of automated daily reporting for P&L statements

Not all P&L statements are created equal. One of the most important considerations for preparing your P&L is the timeframe for reporting. To stay proactive, the standard frequency for running a P&L is daily, or at the very least, weekly.

Before modern restaurant management technology, P&Ls required labor-intensive data tracking and analysis. This reality meant that some restaurant owners only ran P&Ls once a month or once per reporting period.



However, with modern restaurant operations software, you can automate reporting and tracking data through an integration with your Point of Sale (POS) system. Automated daily reporting ensures that preparing your P&L statement is quick and easy.

If you are only running your P&L statement once a month or quarter, by the time you receive your data, it is already outdated. Without the opportunity to make immediate, data-driven decisions with anomalies in P&L numbers, you are leaving money on the table. Running your P&L frequently, through automated daily reporting, allows you to take proactive steps in the moment to counter any immediate problems before they become persistent or costly.

3.3.2 Managing your balance sheet

While your P&L is a key restaurant financial statement, it doesn't tell the full story of your financial health. Your P&L doesn't include how much cash you have on hand or in the bank, the state of your inventory, or if you are staying up to date with your bills. Your restaurant balance sheet is another critical financial report that complements the P&L statement and helps you understand the full picture of your financial health.

3.3.3 Creating your restaurant balance sheet

A balance sheet shows the net worth of a restaurant at a certain moment in time, detailing your restaurant's assets, liabilities, and equity. Your balance sheet empowers you to understand your general financial health in the moment, as well as forecast your short-term and long-term cash flow. With your cash statement in hand, you know whether you are losing money, making money, or breaking even.

There are three main line items in a restaurant balance sheet:

Assets

Restaurant assets are what your restaurant owns, such as cooking equipment or inventory. Assets also include cash on hand.

Liabilities

Restaurant liabilities are what a restaurant owes for a certain period of time, like outstanding vendor bills, rent for property or equipment, lines of credit, or loans.

Balance Sheet — Location Side by Side
As of February 29, 2020

	Company A	Company B	Company C	Total
Assets				
Cash				
Petty Cash	3,453	5,432	2,334	11,219
Operating Bank Account				
Checking - Company A	143,256			143,256
Checking - Company B		152,568		152,468
Checking - Company C			185,794	185,794
Total Operating Bank Account	**143,256**	**152,468**	**185,794**	**481,518**
Total Cash	**146,709**	**157,900**	**188,128**	**492,737**
Inventory				
Food				
Meat	5,435	6,454	9,784	21,673
Bread	2,342	2,349	3,354	8,045
Grocery	2,342	4,513	3,654	10,509
Dairy	1,232	2,145	1,478	4,855
Total Food	**11,351**	**15,461**	**18,270**	**45,082**
Beer	4,651	13,425	21,451	39,527
Total Inventoy	**16,002**	**28,886**	**39,721**	**84,609**
TOTAL ASSETS	**$ 162,711**	**$ 186,786**	**$ 227,849**	**$ 577,346**
LIABILITIES & EQUITY				
Liabilities				
Accounts Payable	23,154	15,795	15,345	54,294
Notes Payable	13,544	16,132	1,035	30,711
Total Liabilities	**36,698**	**31,927**	**16,380**	**85,005**
Equity				
Retained Earnings	46,135	56,813	61,315	164,263
YTD Income	79,878	98,046	150,154	328,078
Total Equity				
TOTAL LIABILITIES & EQUITY	**$ 162,711**	**$ 186,786**	**$ 227,849**	**$ 577,346**

Equity

Restaurant equity tells the life-to-date story of earnings or loss. Equity can be thought of as net assets because it is the difference between assets and liabilities. Part of equity is retained earnings – a restaurant's net income from operations and other business activities retained by the company as additional equity capital. Retained earnings are thus a part of the restaurant's equity. They represent returns on total equity reinvested back into the restaurant.

Bringing it all together

Robust restaurant accounting software, with tools like automated AP and a full POS integration, can help automate the process of tracking expense and revenue data that makes up your total assets, liabilities, and equity.

Once you have collected the information about these three line items, you can view your balance sheet. With your total assets listed on one side, and liabilities on another, your restaurant's net worth is what is left over. Another way to understand the relationship between your assets, liabilities, and equity is with the following formula:

Liabilities + Equity = Assets

3.3.4 Cash flow statement

Keyword

Operating Cash Flow (OCF) is a measure of the amount of cash generated by a company's normal business operations.

Your cash flow statement details your business cash flow, which is money coming in and out of a business. It itemizes the sources and uses of cash – where is your cash coming from and what is using it. This financial statement can help you understand your business health by tracking how much money you have on hand, which may differ from what you have "on paper."

One of the principal insights of a cash flow statement tracks your operational activity. Your operational activity includes the cashflow related to fundamental business operations, and how it flows in and out of your business. Your core operational cash out will include expenses such as your restaurant labor costs, food costs, and services such as advertising. **Operational cashflow** in will primarily include restaurant sales and the selling of assets.

Another key metric recorded in your cash flow statement covers your debt and financing, because taking on debt or financing assets will cause changes in your cash flow. For example, an increase in debt could mean an increase in cash since you are gaining cash from something like a loan or waiting to pay cash on an accounts payable. A decrease in debt can mean a decrease in cash because you are paying off a liability.

Your debt and financing tracking should take into account the difference between short-term and long-term assets. Short-term assets, also called liquid assets, can be easily converted into cash. Short-term assets may include the funds in your bank account or food and beverage inventory. Long-term assets, otherwise known as non-liquid or fixed assets, cannot easily be translated into cash on hand. This may include land, kitchen equipment, or your restaurant building.

Cash Flow Statement

February 1, 2020 – February 29, 2020

Operating	
Net Income	93,456.32
Depreciation and Ammortization	11,033.00
Gain/Loss From Sale of Assets	325.32
Changes in Non-cash Current Assets & Liabilities	35,325.56
Net Cash Provided by Operating Activities	**$ 140,140.20**
Investing	
Cash Payments for Leasehold Improvements	(50,000.00)
Down Payment on Equipment Purchase	(5,000.00)
Proceeds From Sale of Assets	10,000.00
Net Cash Used in Investing Activities	**$ (45,000.00)**
Financing	
Net Borrowings from Line of Credit	20,000.00
Repayment of Note Payables	(2,500.00)
Net Cash Flow Provided by Financing Activities	**$ 17,500.00**
Cash Net Change	**$ 112,640.20**
Cash Beginning Balance	**$ 435,589.32**
Cash Ending Balance	**$ 548,229.52**

Calculating cash flow for a period

When calculating your restaurant's cash flow, first choose your reporting period. Then:

- Start with your restaurant's net income for that period of time.
- Add operational cash inflows. This will primarily be from restaurant sales, and it may also be from sales of any assets.
- Subtract all operational outflows. This will include your operational expenses, any investments, and debt.
- Compare your ending cash with your beginning cash. The difference between these two values is called your "net cash change", otherwise known as your restaurant's cash flow for this reporting period.

Your success as a restaurant is dependent on making smart, data-driven decisions in the moment that set you up for long-term success. Staying up to date and informed about important financial statements, such as your restaurant balance sheet, prepare you to meet operational and financial challenges both today and into the future.

If you would like to easily track financial data and automate financial statements, consider a comprehensive, restaurant-specific management solution. Restaurant365 restaurant accounting software is a cloud-based platform that's fully integrated with your Point-of-Sale system, as well as to your food and beverage vendors, and bank.

3.4 HOW TO READ A RESTAURANT BALANCE SHEET

The balance sheet is a tool that shows you the health of your business. The simplest way to think about a balance sheet is like this: take your digital camera out and take a picture of your business. Print out the photo on your printer immediately. What you will see is a snapshot in time, showing what assets you have and who owns them.

One side of the balance sheet shows the assets of the restaurant. These assets are in the order in which they can most easily be liquidated. For instance, cash can be taken out of the bank today, but a building will take months or sometimes years to sell. The other side of a balance sheet shows the liabilities of the restaurant and to whom they are owed, or if they are a part of the owner's equity. The golden rule to a balance sheet is that it must do exactly that: balance. The total liabilities must equal the total assets. In general you can think of a balance sheet as a document that shows the stuff you have and who owns that stuff.

You have:

- Current Assets - what you're going to use in the next 12 months. Cash in the drawer, cash in the bank, food on the shelves.
- Fixed Assets - what you use over and over again. You furniture, fixtures, equipment.
- Other Assets - things that don't fit in those other two categories, such as your liquor license.
- Current Liabilities - what you have to pay in the next 12 months. Your power bill, your
- Long-term Liabilities - what are the things you pay over and over again, such as a loan on your building.
- Owner's Equity - the part and profitability of the business that's yours, what you own. This is what shows you what you've made or lost over the years.

What do you do with all of this? These numbers come together in one really important calculation called your current ratio.

Current Ratio = Current Assets/Current Liabilities

That should give you a ratio of at least 1:1 - one dollar in current assets to pay one dollar in current liabilities.

Ideally, you'd have a little more in assets to pay liabilities. Some like to aim for 1.25:1. Sometimes you might have a reversed ratio - .90 for every dollar you owe. That's a cash flow issue.

REMEMBER

Doing this calculation and knowing how to read and use the information in your restaurant balance sheet shows you the financial health of your restaurant right now.

ROLE MODEL

LUCA PACIOLI: THE 'FATHER OF ACCOUNTING'

Luca Pacioli was a famous Italian mathematician and a seminal contributor to the accounting field. Some people refer to him as Luca di Borgo after his place of birth called Borgo Sansepolcro in Tuscany.

Early Life

Luca was born in 1445. His father was Bartolomeo Pacioli. However, Luca was not brought up in his parent's house. As a child, he lived with the Befolci family in Sansepolcro. Although very little is known about his early life, many historians have said he received his education in the studio of della Francesca.

While still young man, he left Sansepolcro and went to Venice. In Venice, he entered the service of a wealthy merchant named Antonio Rompaisa. By this time, Luca Pacioli was well educated in basic mathematics from his studies in Sansepolcro. For this reason, he was chosen a tutor to Rompiasi's three sons.

Educational Years

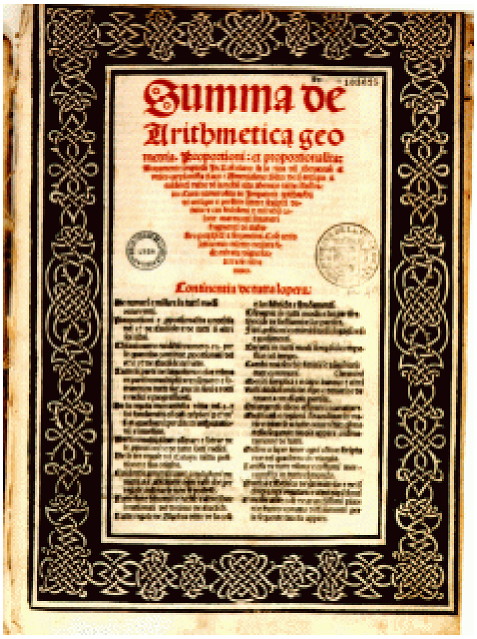
During his stay in Venice, Luca continued his mathematical studies. He studied under Domenico Bragadino. Here he gained a lot of experience in teaching from his role as a tutor. He also gained some knowledge in business from his role in helping Rompiasi's affairs. During this time in 1470, he also wrote his very first work on arithmetic and he dedicated it to his employer's three sons. After this, he left Venice and went to Rome where he spent the next several months.

In Rome, he lived in the home of Leona Alberti. Alberti was an excellent scholar and mathematician who provided Luca Pacioli with great religious connections. Later on, Luca studied theology and for the next few years, he became a friar in the Franciscan Order.

Contributions to Mathematics

In 1477, Luca started a life of traveling. He spent his time teaching mathematics and especially arithmetic at various universities. Between 1477 and 1480, he taught at the University of Perugia. In this university, he wrote his second work on arithmetic – This work was designed for the classes he was teaching. He also taught at Zara and wrote another book on arithmetic. None of the three arithmetic texts were ever published and only the one written for the Perugia students survived. After leaving Zara, Luca taught at the university of Perugia, then at the University of Naples and finally at University of Rome.

Summa de Arithmetica



In 1489, after spending two years in Rome, Luca went back to his home town of Sansepolcro. Back at home, things were not pleasing to him. He was granted privileges by the Pope and this created some degree of jealousy among the religious leaders in Sansepolcro.

In 1491, he was banned from teaching. In 1493, he was invited to preach the Lent sermons. In Sansepolcro, Luca Pacioli worked on one his most popular books entitled *Summa de arithmetica*. He dedicated this book to the duke of Urbino called Guidobaldo. In 1494, he travelled to Venice to publish this book. This book gives a summary of the mathematics known during this time.

The book deals with algebra, arithmetic, trigonometry, and geometry. Despite its lack of originality, the book provided a basis for a major mathematical progress that took place in Europe later on after its publication. *Summa* also studied games of chance. Here, Luca Pacioli studied the problem of points. He gave a solution that was later proven incorrect.

Life in Milan

In 1496, Luca was invited to go to Milan to teach mathematics at Ludovico Sforza's court. At Milan, he became good friends with Leonardo da Vinci, a court painter and engineer. They discussed mathematics and both gained a lot from the discussions. During this time, he started working on *Divina Proportione*.

In March of 1500, the two friends went to Venice and then later returned to Florence where they shared a house. In Florence, Luca was appointed to teach geometry at University of Pisa. He remained here until 1506. During his time in Florence, he got involved in church affairs and mathematics. He even entered the monastery of Santa Croce.

Later Life

In 1510, Luca went back to Perugia to teach again. He also lectured in Rome in 1514 but by this time, he was already old and needed to retire. He went back to Sansepolcro where he died in 1517.

CASE STUDY

OFF-BALANCE SHEET LEASES IN THE RESTAURANT INDUSTRY

The report presents a case about the importance of off-balance sheet leases and in order to facilitate better results, the reports focuses on two companies that are running a chain of restaurants. Further, the report also focuses on leasing versus buying decision and about the accounting implications of leasing.

Additionally, the report also contains a part about the latest emerging issue of capitalizing all the lease obligations and determines how this change will have a substantial impact on the leverage and total debt capacity of the organization. Moreover, the report also distinguishes between off-balance sheet leases and liabilities reported on balance sheet.

Case analysis

1. What are the advantages and disadvantages of leasing over owing a restaurant property? Why does O'Charley's prefer to own its properties and Morton's to use operating leases?

There are different options available to organizations to either lease or buy the restaurant properties and the decision is based on potential benefits, which can be achieved from either of the financing facilities. The major advantages and disadvantages of leasing over owning a restaurant property includes the following,

Advantages:

a) No or little initial outflow

Purchasing a property would require a huge outflow of resources initially, whereas this is not the case for organizations that finance its properties through leasing. Under a lease agreement, an organization would require a little or no initial outflow to finance the strategy, which would improve the working capital of the restaurant and more cash would be available to the organization to grasp the future possible opportunity (Pollert, 2002).

b) Tax advantage

Lease rental payments are an allowable tax expense in calculating taxable profits, which will reduce taxable profits for restaurants, hence, reporting a low tax expense and more profits will be available for shareholders for distribution.

c) Transaction cost may be lower

The transaction cost on lease agreement is lower as compared to the transaction cost associated with purchasing the property. Leasing enables an organization to save heavy admin cost, which could be used by the organization to make the initial down payment (Pollert, 2002).

d) Improves working capital

The lease agreement requires a nil or low initial outflow of resources, so the organization will have heavy cash available to finance the working capital. Further, it will also lead the company to suffer low interest cost on its overdraft facility.

Disadvantages:

a) No ownership

In a leasing agreement, the lessee possesses the rights to use the property but does not own the property. This may be a critical situation epically for the well settled restaurants where the lessor may demand heavy lease payments for the properties.

b) High interest cost

As the lease payments are deferred over the period of the lease term, so the restaurants suffer heavy interest cost. Further, increased interest cost will reduce the interest cover of the organization and will also threaten the credit rating, which will increase difficulty for the organization in raising additional finance or there can also be a possibility that the finance may be raised at comparatively higher interest rate.

c) Early redemption may require heavy outflow of resources

A lease agreement is a formal agreement between the lessee and lessor and any violation in the terms of agreement may require heavy outflow of resources. If the restaurants failed to continue with the leased property then the organizations will have to suffer a heavy penalty.

d) Long term expense than buying on credit

If the property is purchased then the organization will be required to make a one off payment at the designated time period whereas this is not the case in leasing where the organization is required to make regular payments, which will increase the long term expense of the organization (Pollert, 2002).

Morton restaurant group prefers operating lease because the potential sites generally seek major metropolitan areas and the restaurants primarily focus on high end, business oriented clientele where the property purchasing cost is relatively high, so the organization prefers to expand its operations through operating lease whereas, O'Charley's Inc. prefers to expand its operations through owing the properties because they primarily focus on smaller markets where the purchasing price is comparatively low.

2. What were the implied interest rates the two companies used when calculating their capital leases? Using the same respective interest rates, what is the magnitude of the off-balance sheet lease obligations for the two companies at the end of 1999? (Assume that in the lease footnotes "Thereafter" is equal to 10 years for both companies"

Implicit rate is the nominal interest rate implied by borrowing a fixed amount of money in capital lease and returning a different sum of money in future.

By using the same interest rates, the magnitude of the off-balance sheet lease obligations for the two companies at the end of 1999 are different.

SUMMARY

- A restaurant balance sheet lists out a restaurant's assets, liabilities, and equity at a given point in time. This statement can be used to forecast short and long-term cash flow and assess the overall financial health of the restaurant.
- The purpose of the Balance Sheet is to see which way the "scale" is tilted. That is, if you're losing money, making money or breaking even.
- Restaurateurs wanting to scale their restaurant need to be up to date with their balance sheets.
- Assets are what your restaurant owns or generates revenues from, like equipment, inventory, cash in hand, etc.
- Liabilities are expenses and outstanding bills of your restaurant, including property rent, any loans, or vendor bills.
- Restaurant equity is the division of ownership between you and any partners or investors.
- The restaurant balance sheet and restaurant profit and loss statement are both valuable tools for evaluating financial performance. However, they both provide different insights.
- The profit and loss statement shows the amount of profit or loss generated by the restaurant. That is, how sales compared to spending. The balance sheet is intended to show the overall financial situation of the restaurant.
- A profit and loss statement includes data on the restaurant's cost of goods sold, gross profit, and prime cost. This data analyzes the restaurant's performance over a given time period.
- The profit and loss statement is intended to highlight sales data and profits or losses.
- A smart restaurant management software gives you real-time updates about your sales, your growth, the purchase orders made, and thereby the changes in your balance sheet.
- The details of the balance sheet used by restaurants vary based on business size and complexity, the related businesses of the restaurant owners, and the type of organization (sole proprietorship, partnership, or corporation).
- As a restaurant owner or operator, you know that without monitoring, restaurant expenses can easily grow out of control. Your financial statements, such as your restaurant balance sheet and profit and loss statement, are tools to understand your business.

MULTIPLE CHOICE QUESTIONS

1. **The statement of operations is also known as**
   a. The cash flow statement.
   b. The owner's equity statement.
   c. The income statement.
   d. The balance sheet.
   e. The statement of retained earnings.
2. **For a restaurant, food costs are considered**
   a. An indirect cost.
   b. A direct expense.
   c. A loss.
   d. An indirect expense.
   e. A gain.
3. **For a hotel, depreciation expense is considered**
   a. A gain.
   b. A loss.
   c. A direct cost.
   d. An indirect cost.
   e. A direct expense.
4. **Which of the following costs is an indirect cost?**
   a. Salaries and wages
   b. Food costs
   c. Beverage costs
   d. Repair and maintenance costs
   e. Employee benefits costs
5. **Which of the following items is not an undistributed operating expense?**
   a. Property operation and maintenance expenses
   b. Security expenses
   c. Marketing expenses
   d. Food department salaries and wages
   e. Human resources expenses

6. **The Uniform System of Accounts for the Lodging Industry (USAL) income statement is designed for**
   a. Internal management.
   b. Banks.
   c. Shareholders.
   d. Canada Revenue Agency.
   e. Customers.
7. **Fixed charges, or fixed expenses, can also be called**
   a. Noncontrollable costs.
   b. Controllable costs.
   c. Operating expenses.
   d. Controllable expenses.
   e. Operating costs.
8. **Which of the following statements about the Uniform System of Accounts for the Lodging Industry (USAL) is true?**
   a. The USAL makes it difficult to compare financial statements of hospitality firms in the same segment of the industry.
   b. The USAL is a tool that gives low priority to management's need for information on which to base operating judgments.
   c. The USAL provides a convenient and efficient method of presenting the results of operations of specific segments of the industry.
   d. The USAL's specific grouping of revenue and expense items on the balance sheet permits the evaluation of the individuals responsible for a particular unit.
   e. The USAL includes a format of organizing, classifying, and preparing financial statements, but it is not standardized.
9. **Which of the following is the formula for calculating cost of food sold in the food department?**
   a. Net revenue - Allowances - Cost of employee meals
   b. Net revenue - Cost of food - Cost of employee meals
   c. Total revenue - Allowances - Cost of food
   d. Total revenue - Allowances - Cost of employee meals
   e. Total revenue - Allowances - all other expenses

10. Which of the following is the formula for calculating total expenses in the food department?

a. Net revenue - Allowances - Total cost of food - Expenses

b. Total revenue - Cost of food - Gross profit on sales - Other expenses

c. Net revenue - Total cost of food sold - Total payroll and related expenses - Other expenses

d. Total revenue - Cost of food - Gross profit on sales

e. Total revenue - Allowances - Total cost of food - Total payroll and related expenses

Review Questions

1. What is in a balance sheet?
2. What is a balance sheet used for?
3. What does the balance sheet summary?
4. Why is it called a balance sheet?
5. What makes a strong balance sheet?
6. What is recorded in the cash flow statement?

Answer to Multiple Choice Questions

1. (c)	2. (b)	3. (d)	4. (d)	5. (d)
6. (a)	7. (a)	8. (c)	9. (b)	10. (c)

REFERENCES

1. Arya, A., J. C. Fellingham and D. A. Schroeder. 2000. Estimating transactions given balance sheets and an income statement. *Issues in Accounting Education* (August): 393-411.
2. Baber, W. R., S. Kang and Y. Li. 2011. Modeling discretionary accrual reversal and the balance sheet as an earnings management constraint. *The Accounting Review* (July): 1189-1212.
3. Chandra, U., M. L. Ettredge and M. S. Stone. 2006. Enron-era disclosure of off-balance sheet entities. *Accounting Horizons* (September): 231-252.
4. Chen, S., M. L. DeFond and C. W. Park. 2002. Voluntary disclosure of balance sheet information in quarterly earnings announcements. *Journal of Accounting and Economics* (June): 229-251.
5. Churyk, N. T., A. Reinstein and L. Smith. 2018. Jones Enterprises Real Estate Investment Trust: Comparing U.S. and Canadian acquisition accounting, balance sheet and security commission reporting, and initial public offering location. *Issues in Accounting Education* (May): 35-42.
6. De Jager, P. 2014. Fair value accounting, fragile bank balance sheets and crisis: A model. *Accounting, Organizations and Society* 39(2): 97-116.
7. DeFond, M. L. 2002. The balance sheet as an earnings management constraint: Discussion. *The Accounting Review* (Supplement: Quality of Earnings Conference): 29-33.
8. Demerjian, P. R. 2011. Accounting standards and debt covenants: Has the “balance sheet approach” led to a decline in the use of balance sheet covenants? *Journal of Accounting and Economics* (November): 178-202.
9. Dichev, I. D. 2008. On the balance sheet-based model of financial reporting. *Accounting Horizons* (December): 453-470.
10. Ding, Y., G. M. Entwistle and H. Stolowy. 2007. Identifying and coping with balance sheet differences: A comparative analysis of U.S., Chinese, and French oil and gas firms using the “statement of financial structure”. *Issues in Accounting Education* (November): 591-606.
11. Evans, M. E. 2016. Commitment and cost of equity capital: An examination of timely balance sheet disclosure in earnings announcements. *Contemporary Accounting Research* 33(3): 1136-1171.
12. Fischer, D. 2013. The hidden effects of derivatives on bank balance sheets. *The CPA Journal* (September): 67-69.

CHAPTER 4

THE INCOME STATEMENT

"Market values are fixed only in part by balance sheets and income statements; much more by the hopes and fears of humanity; by greed, ambition, acts of God, invention, financial stress and strain, weather, discovery, fashion and numberless other causes impossible to be listed without omission."

- Gerald M. Loeb

INTRODUCTION

An income statement is one of the three important financial statements used for reporting a company's financial performance over a specific accounting period, with the other two key statements being the balance sheet and the statement of cash flows.

Also known as the profit and loss statement or the statement of revenue and expense, the income statement primarily focuses on the company's revenues and expenses during a particular period.

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

1. Discuss on basic income statement for a restaurant
2. Prepare for restaurant income statement examination

The income statement can be prepared in one of two methods. The Single Step income statement totals revenues and subtracts expenses to find the bottom line. The Multi-Step income statement takes several steps to find the bottom line: starting with the gross profit, then calculating operating expenses. Then when deducted from the gross profit, yields income from operations.

Adding to income from operations is the difference of other revenues and other expenses. When combined with income from operations, this yields income before taxes. The final step is to deduct taxes, which finally produces the net income for the period measured.

4.1 BASIC INCOME STATEMENT FOR A RESTAURANT

A restaurant business is unpredictable, and costs that escalate without warning can make all the difference between making or losing money. Your restaurant may be full regularly, but if your overhead and purchase costs are not well under control, the traditionally narrow restaurant profit margin can be consumed rapidly, leaving you wondering where the money went. A basic income statement, also called a profit and loss statement, can show how the business is performing on a monthly basis and enable you to adjust if necessary.

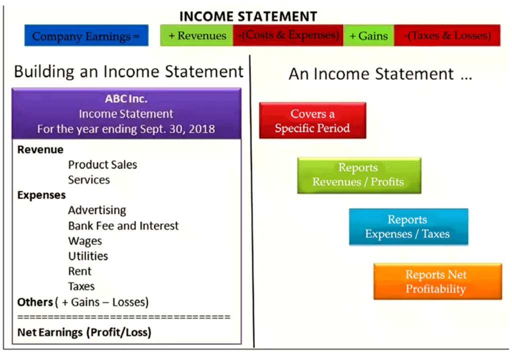


Figure 1. Basic income statement.

A basic income statement represents a snapshot of the restaurant's performance for a specific period, which is usually a calendar month or a 30-day period. It takes account of all income and all expenses, including prepaid expenses and future expenses, depreciation, overheads, and cost of sales for the period in question. It covers expenses that a monthly view might leave out, such as annual taxes, which are due for payment only once a year, but which need to be included in the total to obtain an accurate picture of the restaurant's profitability.

The generally accepted accounting formula for a basic income statement is to deduct the cost of goods sold from the sales to obtain gross profit, then to deduct all other expenses, including overheads, to determine net profit or loss. In the restaurant context, this means deducting the cost of food purchases from the total income, then deducting the overheads, capital equipment costs, and other incidental expenses from the balance. This will give the net profit of the business for the period the income statement covers.

The benefits of producing a basic income statement regularly for a restaurant include the ability to identify good months from bad, and to analyze changes in the cost of goods sold as soon as they occur. For example, grouping expenses such as the cost of food purchases together in one section makes it possible to calculate the total percentage of restaurant income spent on this category. If this cost increases by half a percent over a previous month, you can immediately identify where the increase occurred and adjust your pricing or supply options to counteract it.

The main disadvantage of an income statement is that it represents only a snapshot of the restaurant's value, not the full picture. Accounts receivable and payable, assets, liabilities, and retained earnings, as shown on a balance sheet, would help provide the true value of the business, or what it would be worth if all outstanding monies came in, all debts were paid, and all assets were converted to cash. The basic income statement, though, gives a useful month-to-month view of whether the restaurant is on track to make money out of the menu items it sells.

4.1.1 Profit and Loss Examples for Restaurants

A profit and loss statement; also called an income statement, lists the revenues and expenses of a business during a given period and give a restaurant owner the bottom line on whether it is making money. A restaurant's profit and loss statement will show the owner how much is made from sales and how much was spent on food, labor, rent and other expenses, giving a total picture of the restaurant's profits.

Keyword

Cash flow statement is a financial statement that shows how changes in balance sheet accounts and income affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities.

A profit and loss statement helps business owners better understand their company's financial position. It can display selling trends, find inefficiencies or see opportunities to increase revenues. An accurate income statement also can help a restaurant owner when applying for credit or calculating taxes. Profit and loss statements should not be confused with cash flow statements, which exclusively tracks the cash that a restaurant generates and doesn't take into account credit like an income statement will. For startups, **cash flow statements** are important to help manage expenses that could get confused in an income statement.

■ Restaurant Revenue

Revenue is one half of the profit and loss statement. For a restaurant, it will be all of the sales on food, beverages, catering and merchandise. For most restaurants, food is the top-selling item, while a bar will likely get most of its revenue from beverage sales. Merchandise can include gift cards, t-shirts, mugs, cookbooks, prepackaged food or other novelties. Restaurants can help track sales trends by separating items on the income statement, such as creating separate lines for breakfast, lunch and dinner dining periods or separating sales of beer, wine and liquor.

■ Cost of Goods Sold

One of the primary expenses for restaurants is the cost of goods sold, which is the food, beverages and other inventory. COGS doesn't include other expenses, like labor, rent, insurance, utilities and administrative costs. When compiling a profit and loss statement, the COGS is subtracted from the revenue to get the restaurant's gross profit. This figure is useful in helping to determine the restaurant's profit margin, which is how much revenue it can generate from inventory.

■ Revenue Expenses

Gross profit isn't a restaurant's bottom line. To get that, other expenses must be considered. Payroll costs, including commissions paid, are likely to be the next biggest expense for a restaurant. Operating costs are another category of expenses and can include the telephone bill, maintenance expenses, linens and cleaning, losses from theft and bad debt. Rent, utilities and property taxes are usually categorized as occupancy costs on a restaurant income statement. Other expenses can include property depreciation, insurance and promotion costs.

■ Completing the Income Statement

After all expenses are totaled, that figure should be subtracted from the gross profit, which results in the restaurant's net profit or loss. If the restaurant owner or company made a profit, then income or corporate taxes must be taken out to figure the net income. Income statements can be put together for any period of time, though compiling the report weekly will help restaurant owners have a better understanding of their business.

4.1.2 Gathering Financial Reports for a Restaurant Business

It can be tough to launch a restaurant and keep it afloat. Owners must maintain a thorough understanding of the restaurant finances in order to grow their business. The first step in obtaining this understanding is to implement a sensible accounting system. If you're concerned that your accounting information isn't accurate or that you aren't correctly allocating costs, reach out to a local CPA firm for a consultation.

Inventory Reports. It's critical for restaurants to hit a sweet spot on inventory levels. Unlike other businesses, restaurant owners have to worry about food spoilage or diminished food quality if their inventory sits for too long. Inventory reports can help owners track prices and profitability of their food items. A **balance sheet** style inventory report shows owners a snapshot of inventory stock and value at any moment in time. Restaurant owners can also use sales figures and inventory levels over time to calculate their inventory turnover rate. Both options help managers plan out what food items to purchase and in what quantity.

Keyword

Balance sheet is a summary of the financial balances of an individual or organization, whether it be a sole proprietorship, a business partnership, a corporation, private limited company or other organization such as government or not-for-profit entity.

Income Statement. Restaurants often operate on a fairly thin profit margin. If owners don't have a good handle on their costs, profit margins can easily plummet. Some expenses, like rent, insurance and property taxes, are hard to control. However, managers have more options to play with variable expenses like food and labor costs. An income statement reports profit over a predetermined period of time. Restaurant owners should scrutinize their income statement on a regular basis to ensure operating expenses aren't exceeding sales revenues.

Statement of Cash Flows. Profitable restaurants can go out of business due cash flow problems. This is a serious problem for restaurants that experience feast or famine revenue streams due to seasonal tourism and dining. Income statements can be misleading in regards to cash because most are prepared on an accrual basis. However, just because you've earned revenue doesn't mean you've received the cash. Likewise, you may have recorded an expense but haven't bothered to pay it yet. The statement of cash flows report corrects for these factors and helps managers understand how much actual cash is going in and out of the business every month.

Debt Reports. Brick and mortar businesses like restaurants require a large capital investment. Most restaurant owners have to borrow tens or hundreds of thousands of dollars just to get ready for opening day. High loan payments can hinder a restaurant's options to invest in new growth. The best way to evaluate a restaurant's ability to pay off debt is to evaluate the current ratio based on the company balance sheet. To calculate the current ratio, divide total liabilities by total assets. The higher the ratio, the better the company's financial position in regards to long term debt obligations.

4.1.3 Manage Expenses for a Restaurant Business

Restaurants are businesses with high overhead costs and a high potential for waste. The two largest expense categories are labor and food and beverage. Food and beverage expenses are categorized on financial statements as the cost of sales. All other expenses are listed as operating expenses, though they can be further divided into additional categories.

Salaries and Other Labor Costs: Labor is one of the two major expenses of any restaurant. Examples of labor costs include salaries, wages, benefits, unemployment taxes and service commissions. It can also include the cost of providing employees with uniforms. For most restaurants, labor costs are considered variable as they rely on shift workers and part-time employees that vary according to business volumes. Restaurant managers have to forecast labor needs carefully so that they neither schedule too few or too many employees.

Cost of Goods Sold: The cost of goods sold represents the second largest expense for restaurants: food and beverage costs. Other examples of cost of goods sold include the preparation equipment found in the kitchen, however, these will not be categorized as cost of goods sold on an income statement as most equipment – such as stoves, slicers and other preparation equipment – are depreciated over time. Most restaurants have goals for keeping their food cost at a set percentage, such as 33 percent, of their food sales.

Cost of Goods Sold Formula = Beginning Inventory + Purchases During the Year – Ending Inventory

Marketing and Advertising Expenses: A restaurant's marketing expenses include everything it does to get guests to come and eat food in the restaurant. One of the most important marketing tools is the menu, as it will dictate many of the other expenses a restaurant has. Other examples of marketing expenses include table tents, entertainment, music, coupons, advertising and website expenses.

Real Estate Occupancy Expenses: Occupancy expenses is a category that splits out into all those expenses related to the restaurant's physical building. This can include property taxes, rents, insurance and utilities. It also includes such things as signage and any parking fees or expenses the restaurant might incur.

Repairs and Maintenance: The repairs and maintenance category of expenses can be defined as all those expenses incurred to keep the restaurant operating. These can be divided into the maintenance needs of the building itself, the dining area, the kitchen and the food preparation and cleaning equipment.

Daily Administrative Costs: The administrative costs of a restaurant are very similar to those incurred by other businesses. They can include office supplies, telephone charges, postage and fees to professionals such as accountants and lawyers. Restaurants also must pay a number of licensing fees to local health departments and for beverage licenses, if they serve alcohol.

4.1.4 Evaluate the Average Profit Margin for a Restaurant

As with many statistics, there's no single agreed-upon profit margin for the restaurant industry; conclusions (or educated guesses) vary from source to source. What's clear though and is widely agreed upon, when you look at various estimates for restaurants of every kind, from fast food to fine dining, *is that profits in the restaurant industry are unusually thin.*

There are two profit margins widely used by accounting professionals: gross profit margin and net profit margin. Confusingly, some restaurant journalists write about profit margins without specifying which.

Gross profit, is what is left after you deduct the direct costs of goods sold – such as *food costs and labor costs directly associated with preparation and serving*. It's a useful statistic for professionals evaluating a restaurant's efficiency and profitability, but it's not at all the same thing as net profit – *which includes all costs* – among them are administrative expenses, building costs, taxes and interest. Net profit is what you put in your pocket.

Gross profit margin equals the revenue minus the cost of goods sold divided by revenue. Net profit margin equals revenue minus all costs, direct and indirect, divided by revenue.

When you want to know whether a restaurant is likely to succeed or go under, the best first place to look is at its net profit margin. If the net profit margin is 10 percent – this means that out of every dollar the customer spends – the restaurant pays 90 cents for all expenses, and retains ten cents in profit – which, incidentally, isn't at all bad. The average net profit margin for all S&P 500 companies is a little over 8 percent.

Fast Food Margins. The range of net margins in the fast food industry are quite wide. A few chains, especially McDonald's, have very healthy net margins. In 2017 , the average net profit margin for all McDonald's restaurants was over 22 percent. Among all franchises, however, net margins are drastically lower.

In 2012, for example, when McDonald's had a net profit margin of just under 20 percent; Burger King's net margin was less than a third of that and another big chain; Wendy's, had a scary thin 0.3 percent. This is very bad, but the fast food industry average for 2012 was only somewhat better, at 2.4 percent, a very thin margin that leaves little room for error.

Fast Casual and Casual. Casual dining, as it used to be called, is now commonly divided into two categories: fast casual and casual, sometimes called "family style."

Fast Casual restaurants include Chipotle, Shake Shack and similar chains where you order at the counter, sometimes having the food brought to the table, sometimes carrying at least part of your meal to the table yourself. It's often said that fast casual restaurants are distinguished from fast food chains by their healthier menus, but that may be more an aspiration than an actual difference.

Full-Service Margins. Full-service restaurants are basically what's left after you subtract fast food, fast casual and casual restaurants. This market segment includes fine-dining restaurants, but it also includes less elegant places where, as in the fine dining segment of the industry, you're ushered to a table and handed a menu. The difference between fine-dining and other full-service restaurants isn't that the approaches are entirely different – both are "full-service" – but in the degree of refinement and, yes, how much it costs. The Houston's restaurant chain is probably right at about the dividing line between "full-service" and "fine-dining.

In 2017, full-service restaurants had average profit margins of 6.1 percent, essentially the same margin as fast-casual and casual restaurants.

Did You Know?

In 2013, the fast casual segment of the restaurant industry had an average net profit margin of 6 percent. Overall, the fast-casual and casual segments together also averaged 6 percent net profit margins. To put this in context, this is a little more than 2 percent worse than the average of all S&P 500 companies, but nearly three times better than the fast food segment.

4.1.5 Calculate Net-Profit Margin from a Restaurant

As an owner or operator of a restaurant, there are several key pieces of financial information that you will need to understand. Net-profit margin, and what directly affects this financial ratio, is probably most important. The net-profit margin directly correlates to how much money the restaurant receives and makes over the course of a period of time.

Net-Profit Margin. You calculate net-profit margin by dividing net income by sales. Each of these variables are found on the income statement for a restaurant, or chain of restaurants. This financial ratio shows how much sales remain once all expenses of the restaurant are paid. Therefore, if your restaurant operates with a 30 percent net-profit margin, then $.70 of each sales dollar goes toward paying expenses and $.30 goes toward profits.

$$\text{Net Profit Margin Formula} = \frac{\text{Net Profit}}{\text{Total Revenue}} \times 100$$

Food Costs. There are two primary types of expenses that greatly affect the net-profit margin of a restaurant; food costs and labor expenses. Food costs include the purchase price of all food and beverages. Waste and theft are big concerns within the restaurant industry. Food-safety measures and spoilage can cause food costs to soar, as can theft of expensive foods or alcohol. The weather and economy also play significant roles in determining what your foods are in your restaurant. A bad storm, drought or rising gasoline prices can cause food prices to climb, which translate into increasing food costs for a restaurant.

Labor Expenses. The second expense that is of great concern to managers and owners of restaurants is labor. Labor costs include the wages and salary of management, chefs, cooks, dishwashers, hostesses, servers, **bartenders** and any other person that the restaurant employs. Reducing these expenses by "cutting" people, letting them clean up and go home, after the restaurant's rush can help to increase the net-profit margin of the business.

Keyword

Bartender is a person who formulates and serves alcoholic or soft drink beverages behind the bar, usually in a licensed establishment.

Menu Prices. Increasing menu prices can help to offset rising food or labor costs. It can also aid in increasing the net-profit margin of a restaurant. However, if you increase your prices by too much or do not keep them in line with the quality of the food, the demand for your restaurant will decline. This will actually cause the net-profit margin to decrease over time since many of your overhead costs will not go down despite less food being sold. This is important to keep in mind when considering ways in which to increase the overall profits of the business.

4.1.6 Who uses an income statement?

There are two main groups of people who use this financial statement: internal and external users. Internal users include company management and the boards of directors, who use this information to analyze the business's standing and make decisions in order to turn a profit. They can also act on any concerns regarding cash flow. External users comprise investors, creditors, and competitors. Investors check whether the company is positioned to grow and be profitable in the future, so they can decide whether to invest in the business. Creditors use the income statement to check whether the company has enough cash flow to pay off its loans or take out a new loan. Competitors use them to get details about the success parameters of a business and get to know about areas where the business is spending an extra bit, for example, R&D spends.

The following information is covered in an income statement. The format for this document may vary depending on the regulatory requirements, the diverse business needs and the associated operating activities.

Revenue or sales: This is the first section on the income statement, and it gives you a summary of gross sales made by the company. Revenue can be classified into two types: operating and non-operating. Operating revenue refers to the revenue gained by a company by performing primary activities like manufacturing a product or providing a service. Non-operating revenue is gained by performing non-core business activities such as installation, operation, or maintenance of a system.

Cost of goods sold (COGS): This is the total cost of sales or services, also referred to as the cost incurred to manufacture goods or services. Keep in mind that it only includes the cost of products which you sell. COGS does not usually include indirect costs, like overhead.

Gross profit: Gross profit is defined as net sales minus the total cost of goods sold in your business. Net sales is the amount of money you brought in for the goods sold, while COGS is the money you spent to produce those goods.

Gains: Gain is a result of a positive event that causes an organization's income to increase. Gains indicate the amount of money realized by the company from various business activities like the sale of an operating segment. Likewise, the profits from onetime non-business activities are also included as gains for the business. For example, company selling off old vehicles or unused lands etc. Although gain is considered secondary type of revenue, the two terms are different. Revenue is the money received by a company regularly while gain can be accounted for the sale of fixed assets, which is counted as a rare activity for a company.

Expenses: Expenses are the costs that the company has to pay in order to generate revenue. Some examples of common expenses are equipment depreciation, employee wages, and supplier payments. There are two main categories for business expenses: operating and non-operating expenses.

Advertising expenses: These expenses are simply the marketing costs required to expand the client base. They include advertisements in print and online media as well as radio and video ads. Advertising costs are generally considered part of Sales, General & Administrative (SG&A) expenses.

Administrative expenses: It can be defined as the expenditure incurred by a business or company as a whole rather than being the ones associated with specific departments of the same company. Some of the examples of administrative expenses are salaries, rent, office supplies, and travel expenses. Administrative expenses are fixed in nature and tend to exist irrespective of the level of sales.

Depreciation: Depreciation refers to the practice of distributing the cost of a long-term asset over its life span. It is a management accord to write off a company's asset value but it is considered a non-cash transaction. Depreciation mainly shows the asset value used up by the business over a period of time.

Earnings before tax (EBT): This is a measure of a company's financial performance. EBT is calculated by subtracting expenses from income, before taxes. It is one of the line items on a multi-step income statement.

REMEMBER

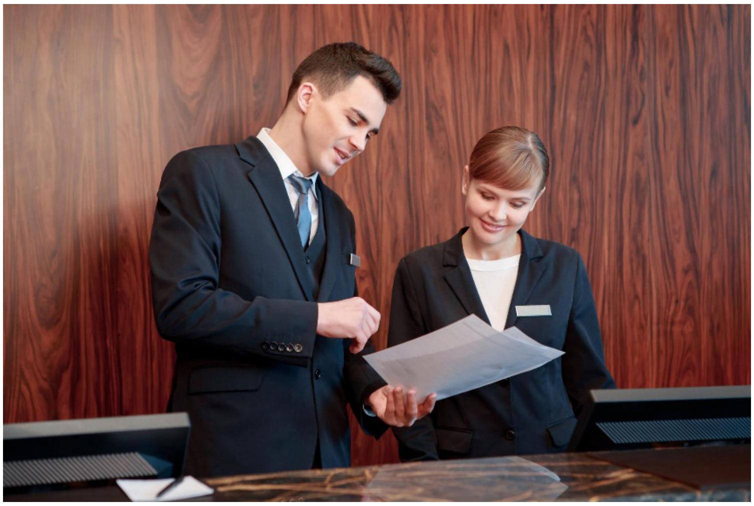
Expenses generated by company's core business activities are operating expenses, while the ones which are not generated by core business activities are known as non-operating expenses. Sales commission, pension contributions, payroll account for operating expenses while examples of non operating expenses include obsolete inventory charges or settlement of lawsuit.

Net income: Net profit can be defined as the amount of money you earn after deducting allowable business expenses. It is calculated by subtracting total expenses from total revenue. While net income is a company's earnings, gross profit can be defined as the money earned by a company after deducting the cost of goods sold.

4.1.7 Write an Income Statement

To write an income statement and report the profits your small business is generating, follow these accounting steps:

1. **Pick a Reporting Period.** The first step in preparing an income statement is to choose the reporting period your report will cover. Businesses typically choose to report their income statement on an annual, quarterly or monthly basis. Publicly traded companies are required to prepare financial statements on a quarterly and annual basis, but small businesses aren't as heavily regulated in their reporting. Creating monthly income statements can help you identify trends in your profits and expenditures over time. That information can help you make business decisions to make your company more efficient and profitable.



2. **Generate a Trial Balance Report.** To create an income statement for your business, you'll need to print out a standard trial balance report. You can easily generate the trial balance through your cloud-based accounting software. Trial balance reports are internal documents that list the end balance of each account in the general ledger for a specific reporting period. It will give you all the end balance figures you need to create an income statement.
3. **Calculate Your Revenue.** Next, you'll need to calculate your business's total sales revenue for the reporting period. Your revenue includes all the money earned for your services during the reporting period, even if you haven't yet received all the payments. Add up all the revenue line items from your trial balance report and enter the total amount in the revenue line item of your income statement.

4. **Determine Cost of Goods Sold.** Your cost of goods sold includes the direct labor, materials and overhead expenses you've incurred to provide your goods or services. Add up all the cost of goods sold line items on your trial balance report and list the total cost of goods sold on the income statement, directly below the revenue line item.
5. **Calculate the Gross Margin.** Subtract the cost of goods sold total from the revenue total on your income statement. This calculation will give you the gross margin, or the gross amount earned from the sale of your goods and services.

6. **Include Operating Expenses.** Add up all the operating expenses listed on your trial balance report. Enter the total amount into the income statement as the selling and administrative expenses line item. It's located directly below the gross margin line.
7. **Calculate Your Income.** Subtract the selling and administrative expenses total from the gross margin. This will give you the pre-tax income. Enter the amount at the bottom of the income statement.
8. **Include Income Taxes.** To calculate **income tax**, multiply your applicable state tax rate by your pre-tax income figure. Add this to the income statement, below the pre-tax income figure.

Keyword

Income tax is a type of tax that the central government charges on the income earned during a financial year by the individuals and businesses.

9. **Calculate Net Income.** To determine your business's net income, subtract the income tax from the pre-tax income figure. Enter the figure into the final line item of your income statement.
10. **Finalize the Income Statement.** To finalize your income statement, add a header to the report identifying it as an income statement. Add your business details and the reporting period covered by the income statement.

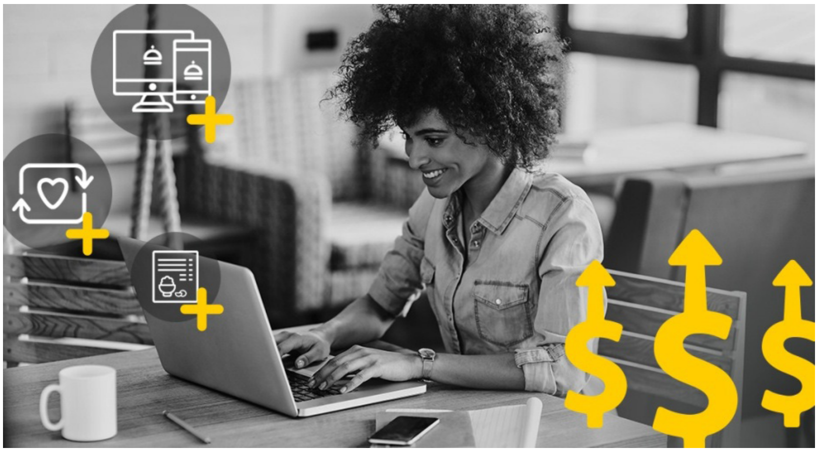
4.1.8 Read a Profit-Loss Report for Restaurants

A restaurant's profit-and-loss report is also known as a profit-and-loss statement or an income statement and provides information to determine how well its operations performed during an accounting period. The statement shows a restaurant's revenues, expenses and either its profit or loss for the period. Understand how to read each section of the report to analyze a restaurant's performance.

Sales Revenues. The first section at the top of a restaurant's profit-and-loss statement shows its sales revenues, which are separated into different categories, such as food revenues and beverage revenues. Revenue is money a restaurant earns from selling its food and beverages before paying any expenses. Review the amounts listed in this section to determine the amount of business the restaurant achieved during the period. Higher revenue generally suggests that it attracted more customers.

Cost of Sales and Gross Profit. Cost of sales is the money a restaurant spent on the food and beverages it sold during the period. A restaurant's profit-and-loss statement shows cost of sales listed as separate amounts for food and beverage below the sales revenue section. Gross profit, which equals total sales revenue minus total cost of sales, is listed below cost of sales. Look at gross profit to determine how much profit the restaurant generated before paying operating expenses.

Operating Expenses and Operating Income. Read through each item in the next section, the operating expenses section, to determine the expenses incurred in the restaurant's operations. Examples of operating expenses include staff wages, repairs and maintenance, and occupancy costs, such as rent and property taxes. Operating income is listed below the operating expenses section and equals gross profit minus total operating expenses. Identify this amount to determine a restaurant's core operating profit before paying interest expense or income taxes.



Interest, Income Taxes and Net Income. The statement shows the non-operating expenses of interest expense and income tax expense below operating income. Review these to determine the expense the restaurant incurred from borrowing money and the amount it must pay tax authorities. Next, identify the restaurant's net income or net loss on the bottom line of the statement. This important line shows the overall profit or loss for the period, which equals operating income minus interest expense minus income tax expense. Net income, or profit, is a positive number, while a loss is negative.

4.2 RESTAURANT INCOME STATEMENT EXAMINATION

The income statement, which is a record of the money that comes in and the money that goes out. This shows you what your customers paid you, along with what you paid to keep your restaurant running. The difference between the two is your profit. This income statement is also used when filing your taxes, so it serves a dual purpose: letting you know how much profit you are making, and helping you file your taxes.

The best way for you to create an income statement is with the use of a template. You can create your own, or you can use one from an accounting program.

Your template needs to include all your sources of income along with all your expense sources. Each source needs its own line. You first list your income followed by your expenses. Your expenses will be listed in two separate categories. The first category is your expenses related to the food and drink you sold. Your income minus your food expenses is your gross profit. The next category is your expenses related to your operations. Your gross profit minus your operating expenses is your net operating income. Each income and expense item will have its own line.

Dates: ________

Income	Amount
Food Sales	$
Drink Sales	$

Expense	Amount
Food Costs	$
Drink Costs	$

Gross Profit	Food and drink sales minus food and drink costs

Operating Expenses	Amount
Wages	$
Rent	$
Insurance	$
Utilities	$
Office supplies	$
Total operating expenses	Sum of operating expenses

Net Operating Income	Gross profit minus operating expenses

You can create income statements that show you your profit for the day, for the week, for the month, or for the year. This helps you decide how you can grow your business.

Once you have your template set up with all your necessary income and expense items, you can then fill it in. Your income statement might look something like this:

Dates: November 2016

Income	**Amount**
Food Sales	$40,325.76
Drink Sales	$32,567.82

Expense	**Amount**
Food Costs	$22,329.94
Drink Costs	$8,532.93

Gross Profit	$42,030.71

4.2.1 Create a Restaurant P&L Statement

1. **Choose a Timeframe.** The first step in creating a restaurant profit and loss statement is selecting a timeframe. You can create P&L statements weekly, monthly, quarterly, or annually. It's a good idea to generate these statements regularly so you always have a clear sense of how various aspects of your business are affecting costs and sales. On your statement sheet, enter your restaurant name and the selected timeframe for your data.
2. **Record Sales for the Selected Timeframe.** The first section to fill in on an income statement is the sales section. The sales section shows you how much money your restaurant brought in during the given period. In a pre-filled income statement template, you'll see sections for food, wine, beer, liquor, and soft drink sales. You can choose to track sales more specifically by segmenting your food sales into more targeted categories or menu groups. Or you can simplify your P&L statement by dividing sales into just food and beverage.

If you have a restaurant **POS system** that offers sales tracking and reporting, you can easily access detailed sales information for your selected timeframe.

Keyword

Point of sale (POS) system is the spot where your customer makes the payment for goods or services that are offered by your company.

3. **Enter Cost of Goods Sold (COGS).** COGS is really just another way of saying the cost of the inventory used to create the food and beverage items sold during your selected time period.

If you use standardized recipes for all of your food and drink items, it should be fairly easy to calculate your cost of goods sold. For instance, if you sell 10 chicken dishes and each dish costs $5 to create based on your inventory costs, then your COGS is $50 (10 x $5).

4. **Labor.** Labor includes all salaried and hourly employees, as well as payroll taxes and employee benefits. You should calculate the amount you spent on each of these labor-related expenses during the time period you selected and enter them individually into the income statement template.
5. **Operating Expenses.** Operating expenses are the controllable expenses involved in running your day-to-day operations. This could include things like supplies, repairs and upgrades, marketing and advertising, and music and entertainment.
6. **Occupancy Costs.** Occupancy expenses are the fixed overhead costs related to things like rent, real estate, and property insurance. These costs are fixed because you cannot alter or change them.

7. **Depreciation.** Depreciation refers to the decreasing value of an asset (in this case the physical restaurant establishment and equipment) overtime. Although depreciation is inevitable, it still needs to be accounted for in order to accurately calculate your net profit or loss.

4.2.2 Restaurant Profit and Loss Statement Strategy

While there are several ways to measure and ensure the success of your restaurant, the best way to understand your restaurant's financial progress is with a restaurant profit and loss statement. Also known as a restaurant P&L statement, this financial tool reflects your sales and costs during a specified period of time. To better understand your business's growth, see our guide below to create and interpret your own restaurant profit and loss statement.

A profit and loss statement (or income statement) is a monetary statement that lists the sales, costs, and expenses of your business in a set period of time. For a restaurant, this financial statement enables you to analyze your restaurant's financial progress. You'll be able to see exactly where your restaurant is making or losing money, so you can take the necessary steps to improve your bottom line.

Restaurant profit and loss statements can be used weekly, monthly, or yearly. Weekly statements are recommended so you can keep track of what is most profitable or costly to your establishment each week. This allows you to quickly make changes, such as implementing strategies to lower food costs that will ensure your restaurant's financial success. Many restaurants will also use monthly and yearly restaurant profit and loss statements to show overall progress.

A restaurant P&L statement usually includes the following 5 main sections:

- Sales Breakdown
- Costs breakdown: Cost of goods sold (COGS)
- Labor Costs
- Operating Costs
- Net Profit or Loss

P&L statement also enables you to calculate food cost percentage, gross profit, and net profit or loss. These metrics can be calculated from your sales, COGS, and costs, and they allow you to fully understand your restaurant's financial state.

Here, we go through what is included in a restaurant income statement in detail.

- Section 1: Sales

In this section, you should list out all of the items that contribute to your total sales. This will include the products from all of your revenue streams and how much money each specific item has brought in.

- Section 2: Costs

In this section, include a list of all of your restaurant's expenses with a cost of goods sold analysis. The cost of goods sold (COGS) is the total cost of your food and beverage inventory for a given time period. You can list out each individual item using your existing inventory system, calculate the cost of each product, and add them up to get your total COGS. Later, we will go through the equation for COGS and other useful restaurant calculations.

- Section 3: Labor Costs

From your head chefs to your bussers, salaries and hourly wages for all employees make up your restaurant labor cost. The key element to controlling your restaurant labor cost is to understand how many employees you need to provide consistent and effective service without scheduling too many people.

- Section 4: Operating Costs

Restaurant operating expenses include everything involved in your daily operations, such as supplies, repairs, and marketing. You can include occupancy expenses here or choose to make a separate section. Occupancy expenses include overhead costs and everything related to occupying a space, such as rent, insurance, utilities, taxes, and waste removal. Some of these **expenditures**, like waste removal, may be fixed, whereas others, such as your gas bill, may vary.

- Section 5: Net Profit/Loss

In this final section, insert the results of your calculations and see how your restaurant performed over the designated period of time. Add up your costs (COGS, Labor, Operating) and compare it to your total income. Ideally, you'll end up with a profit. If you get a negative number, you're in the red, which means you're spending more than you're bringing in. You'll need to adjust your budget at that point to ensure that your next pay period ends in a profit or else you may not be able to sustain your business in the long run.

Keyword

Expenditure is an outflow of money, or any form of fortune in general, to another person or group to pay for an item or service, or for a category of costs.

4.2.3 Restaurant Profit and Loss Template

It's a good idea to create your own restaurant profit and loss template so you can customize it to your unique costs. The table below is an example of what your P&L may look like. You can also use our free downloadable profit and loss statement template by clicking the button below.

Restaurant P&L Table

RESTAURANT PROFIT AND LOSS STATEMENT, JANUARY 2021			
Sales	**Week of Jan 9**	**Week of Jan 16**	**Week of Jan 23**
Food	10,500	9,000	11,000
Wine	2,000	1,750	2,750
Beer	1,250	1,500	1,750
N/A Beverages	1,500	1,500	1,250
Merchandise	750	1,250	1,000
Catering	1,000	1,000	0

TOTAL	17,000	16,000	17,750
COGS			
Food	3,500	2,750	3,750
Wine	800	600	900
Beer	400	500	550
N/A Beverages	250	250	200
Merchandise	300	500	400
Catering	500	300	0
Total COGS	5,750	4,900	5,800
Gross Profit	11,250	11,100	11,950
Labor Cost	3,750	3,500	4,000
Operating Costs			
Miscellaneous	200	100	150
Rent	600	600	600
Utilities	400	400	400
Property Tax	150	150	150
Waste Removal	75	75	75
Insurance	125	125	125
Equipment Repairs	50	0	0
Total Operating Cost	1,600	1,450	1,500
Net Profit/Loss	5,900	6,150	6,450

Restaurant Calculations for Your P&L Statement

Several restaurant calculations can help you create your profit and loss statement and glean important information from it. Below we go through how to calculate the cost of goods sold, food cost percentage, total gross profit, and net profit.

Metric	What is it?	Equation	Example
Cost of Goods Sold (COGS)	• The cost to your restaurant of the food, beverages, and any other products sold in a given time period • Also known as cost of usage or cost of sales	Beginning Inventory + Purchases – Ending Inventory = COGS	**$4,000** (beginning inventory) **+ $3,000** (purchased inventory over the week) **- $1,250** (ending inventory) **= $5,750** (COGS) • Repeat for every product individually or add up your inventory at once to get your total COGS.
Food Cost Percentage	• The portion of sales spent on food • Average food cost percentage ranges from 25-35%	Total COGS / Food Sales = Food Cost Percentage	**$5,750** (Total COGS) **/ $17,000** (Food sales) **= 33%** (Food Cost Percentage)
Gross Profit	• The profit made from your sales after deducting the cost of goods sold • Can be thought of as a preliminary profit because it only takes into account sales and goods	Total Sales – COGS = Gross Profit	**$17,000** (Food Sales) **- $5,750** (Total COGS) **= $11,250** (Gross Profit)
Net Profit/ Loss	• The actual profit or loss after all expenses are deducted from sales • Also known as the bottom line, net income, or net earnings	Gross Profit – (Labor Cost + Operating Costs) = Net Profit/Loss	**$11,250** (Gross Profit) **-($3,750 +$1,600)**(Labor Cost + Operation Cost) **= $5,900** (Net Profit)

Customize Your Restaurant P&L Statement

A restaurant P&L is customizable to your needs, so it is wise to avoid relying on another restaurant's profit and loss statement as an example to follow. Yours can be as rudimentary or elaborate as you like. Additionally, you can break down your operating expenses into smaller sections, such as occupancy expenses and marketing. Either way, your P&L statement will be most helpful to your business if it includes the precise costs and gains uniquely relevant to your establishment.

4.2.4 The Parts of a Complete Profit and Loss Statement

Getting the most out of your P&L starts with understanding all of its parts. Here are some of the most important items within your P&L, how they relate to each other, and how they can add context to your understanding of your business.

Gross Margin

A gross margin is the financial result of operating activities, usually expressed on an income statement as [sales – cost = profit]. Operating activities are generally defined as "core business activities."

The "big three" core business activities for a restaurant are selling food and beverage (revenue), producing food and beverage (cost of goods sold or CoGS), and labor – employing sales (front of house) and production staff (back of house). The combination of CoGS and labor is generally referred to as "prime cost," since these are the primary expenses involved in producing revenue. Think of these as costs that are essential to selling goods (you couldn't sell the wine without the wine and the person to sell the wine, for instance).

Each menu item has its own profit margin as expressed by [menu price (revenue)] – [CoGS] = [gross margin] (or gross profit).

Prime Costs and Controllable Profit

Prime cost is the total of cost of sales plus all payroll-related costs, including management salaries, hourly staff, and payroll taxes and benefits. Prime costs are the majority of the costs that are controllable by management in the short term, and controlling these costs is the best and most direct way to increase your net profit.

The closer a cost is tied to sales (such as CoGS and hourly labor), the more control your management has on the final number on the P&L. Management is able to influence controllable costs and profit to a much greater degree than non-controllable and fixed expenses like rent, taxes, interest, and insurance.

There are some operating expenses that are generally grouped into categories such as direct operating expenses, marketing, and utilities. Operating expenses tend to be the most flexible, but there are a number of expenses that don't bend to management influence.

If your dishwasher breaks, you have to fix it. If you break a tray of glasses, you must replace them. You have to pay your utility bills to keep the lights on. You can introduce new policies to prevent future breakage and reduce energy consumption, but you will continue to incur these costs regardless of sales or customers.

example

Cost of Goods Sold (CoGS)

"Cost of goods sold" is the raw material costs of your menu items – the actual amount of food and beverage used to produce your food and beverage sales.

[Beginning inventory of F&B] + [Purchases] – [Ending inventory] = CoGS for the period

Or:

The amount of food and beverage you start with:

[Beginning inventory] + The amount of food and beverage you bought: [Purchases] – The amount of food and beverage left: [Ending inventory] = The amount of food and beverage used: [CoGS]

Beginning inventory is the amount of food and beverage you have in stock on the first date for the date range you're reporting on.

Purchases during that same period are all food and beverage invoices added to your inventory.

Ending inventory is the food and beverage items you still have at the end of the same period.

Normally, CoGS is expressed as a ratio of a percentage of cost-to-sales. These ratios are usually categorized as follows:

Revenue / Cost	Standard ratio range (%)
Food cost / Food sales	25–40%
Beverage (non-alcoholic) cost / Beverage (non-alcoholic) sales*	10–30%
Wine cost / Wine sales	30–50%
Draft beer cost / Draft beer sales	20–40%
Bottled (canned) beer cost / Bottled (canned) beer sales**	30–35%
Liquor cost / Liquor sales	10–20%
Bar mix and consumables cost / Liquor sales***	5–25%

Generally accepted ratios vary from market to market and concept to concept. Your percentage of costs will be largely determined by how much you sell something for versus how much it costs to produce. The cost percentage will be generally determined by the bestsellers on your menu, rather than the menu as a whole. As a general rule, your combined CoGS and labor costs should not exceed 65% of your gross revenue – but if your business is in an expensive market, you should aim for a lower percentage.

*Food and non-alcoholic beverage are sometimes combined, but this is less common.

**Draft and bottled beer is sometimes combined, but this is not recommended. The serving, storing, and pouring methodology for each is different, as are the costs.

***Bar consumables are sometimes combined with non-alcoholic beverage or liquor; use your own discretion to determine with your accountant if this is right for your restaurant.

Theoretical Cost. While your theoretical cost is not part of your P&L, it's important to compare your theoretical CoGS to your actual CoGS on your P&L statement. "Theoretical cost" is your ideal spend – but the cost of the food and beverage you actually used is not always equal to what you should have used based on your recipes. Raw material costs can change, and then there's waste, inconsistent portioning, and shrinkage (the polite term for employee theft) – these can all create differences in theoretical versus actual costs. Your accountant will produce your actual cost using your inventory and invoices as inputs.

Part of managing and analyzing restaurant costs is to consistently compare what should have happened (theoretical CoGS) with what actually happened (actual CoGS) – and then work on narrowing the gap.

Expense Report. While your expense report is separate from your P&L, you'll want to refer to it if you notice any discrepancies in your expenses on your P&L. Your expense report is your line-by-line breakdown of all invoices, the total of which are reflected in your P&L. Your accountant should provide a detailed expense report that you can refer to if you notice you've spent WAY more on, say, music and entertainment from one month to another.

4.2.5 Restaurant Profit and Loss Statements: Creating Them

A restaurant profit and loss statement also referred to as a restaurant P&L, shows your business' costs and revenue (net profit or loss) during a specified period of time. In other words, your P&L functions as a bank statement for your hospitality organization to monitor your company's financial health. Calculating the profitability of most food service establishments comes down to basic fundamental business components: increasing sales or margins (revenue) and reducing costs or expenses. Statistics show that 50% of new restaurants go out of business by year 5 because they fail to make a profit.

A restaurant P&L statement is a pretty common financial reporting method for determining your restaurant's profitability; where this might get a little confusing knows what to actually include in your restaurant's P&L statement. This restaurant P&L guide will walk you through the essential steps for creating a restaurant P&L report. So, whether you chose to have a restaurant CPA generate your P&L or you use accounting software to create it yourself, you will have a better understanding of reading and reviewing one.

REMEMBER

Every business is different, so you can customize your P&L to your company's needs; you don't have to take a generic restaurant profit and loss example statement as the testament to follow. You can make your statement as simple or elaborate as you want, but remember it will be more helpful to understand your accounts if you provide details of the costs and gains most relevant to your establishment.

Another thing to mention is that the restaurant labor cost is usually listed as a separate expense between COGS and operating expenses. To figure out where your largest profits or losses have occurred, get more **granular** and break down your revenue and costs into smaller, more specific sections.

Revenue: Revenue is the profits you earn from selling items and goods to your customers. Most restaurants will make their highest profits from their sales of food and beverages, but some chains will have other forms of revenue. Make sure you list each form of income separately on your Profit and Loss statement.

Food and Beverage Sales: In this category, you can break line items down into smaller subset sections under food, beer, wine and coffee. Depending on what kind of hospitality business you have, one section may be more profitable than others for you. If you run a boutique coffee shop in Brooklyn, your coffee sales will likely be higher than selling food items. If you are a high-end steak house, you may generate more profits from food dishes than you do from selling wine.

Other Business Ventures

- **Merchandise Sales**– this could include any items that are sold or function as promotions for your restaurant. Merchandise could include gift cards, t-shirts, mugs or hats. The chain Hooters does a lot of merchandising, sales and promotion.
- **Catering** – this is a great way to reach out to a new neighborhood and introduce people to your cuisine. This could include doing high end special events or private parties, and it could include selling snacks for a fundraiser or local school event. If your restaurant does any catering, make certain to list it as separate income item, on your P&L statement.

Costs: Your restaurant's costs should include any type of expense, such as inventory purchases, insurance costs, and employee paychecks. The three main expenditures you will encounter as a manager include the cost of goods sold, restaurant labor cost and restaurant operating expenses which is usually listed as separate line items on the P&L statement.

Cost of Goods Sold: The cost of goods sold (COGS) metric, or sometimes referred to as cost of usage, records the amount of money you spend on food ingredients and beverages that you supply to your customers. If your restaurant has merchandise or a catering division, you should put those in COGS also. To understand how the COGS works, you must calculate how much you end up spending on inventory to fulfill your sales transactions to your patrons. Also, menu pricing is an important aspect to understand, especially if you are competing with many other similar food establishments. Some restaurants use a tactic, called the portion control method, to decrease the amount of inventory they use each week by small amounts, which helps them to keep more in stock for the next week and thus lowering their COGS.

Restaurant Labor Costs: The wages and salaries of all your staff, from your head chef to your waiters, will determine your labor costs. This can include payroll taxes, worker's compensation, and group insurance benefits. The most important element to balance, that will help control your labor cost, is to figure out exactly how many employees you need each week in order to provide effective service without over scheduling. Depending on how busy you are, every restaurant needs a chef, some servers, and hostess. This category offers significant cost containment opportunities. Labor costs can be improved with knowledge of a required resource allocation to demand, over-time prevention and continuous improvements in productivity – employee, or physical components of the business, e.g., labor saving equipment, optimized floor plans, etc. A smart restaurateur will figure out how to have some control over the amount spent on labor expenses, making a determination on which employees are an absolute necessity to have on the payroll full time.

Restaurant Operating Expenses: Operating expenses will include costs on everything from tablecloths to rent. Now, depending on what type of hospitality business you have, your expenses and vary immensely. Below is a chart listed with some of the most common restaurant expenses you should account for, but some of these may or may not be the most relevant to your type of eatery or bar.

Occupancy Expenses: These costs or expenses include the nuts and bolts of running your business, which includes property taxes, utilities, interest, depreciation, rent and waste removal. Keep in mind to carefully review your **leasing agreement**, because some expenses may vary where others like the waste removal may be a fixed cost. Another thing to be on the lookout for are possible unforeseen expenses like equipment, or even building, repairs that are a necessity to the safety and success of the business.

Restaurant Insurance Cost: Insurance is a must have element when running a business which can cost thousands of dollars a year, based on the extent of the risk coverage you want. Your restaurant's insurance costs may include coverage for worker's comp, business crimes, general liabilities, loss of income, equipment breakdown or even property damage. It is recommended you shop around from a few vendors to see all your options.

Keyword

Leasing agreement is considered as the most important legal form because it legally binds two or more parties often referred to as the landlord and tenant.

Controllable Expenses: You can think of miscellaneous costs as any daily expense that is necessary to your restaurant's business such as the restocking of linen uniforms, cleaning supplies, napkins, paper cups, replacing glassware etc. You also can also include advertising here. Some expenses will obviously vary depending on the type of establishment you run. As an example, when comparing a 5-star Manhattan restaurant to a fast food chain, the 5-star restaurant will invest in more fancy chinaware and the fast food chain will purchase more disposable cups.

Prime Cost: The prime cost is the sum of a restaurant's food, beverage and labor costs. Some restaurant owners will consider this their profitability benchmark number on their P&L statement. Because the prime cost bundles the two largest cost categories, it represents a key indicator into whether the company will be profitable in the next reporting period. Prime cost is also a direct reflection as to how management is controlling food, beverage and labor costs on a daily basis throughout the reporting period. A successful restaurant will keep its prime cost at 65% or lower.

Net Profit / Loss: At the bottom, of the P&L statement, you must list your net profit or loss based on your costs and revenue. You calculate your net profit or loss by subtracting both the labor costs and the operating costs from your gross profit. Your revenue obviously needs to be higher than all your combined costs for you to generate a profit.

Remember, your profit and loss statement should include only what is most relevant to your particular culinary business. Bookkeeping Chef's software, platform makes it easy to create and read accurate P&L statements so that you can understand your financials and grow your business. Remember that successful businesses use and rely on data to make decisions. In order to understand how to increase the profitability of your restaurant, you need to first have a clear sense of how your restaurant is currently performing. How much are you spending on labor? How much does it cost you to create each of your menu items? Which menu items are the best and worst sellers? After considering your controllable costs like payroll and food costs, is there enough money to cover your overhead costs? By regularly creating income statements and tracking your prime cost over time, you will start to recognize trends and areas that need more attention so you can make the appropriate adjustments.

CASE STUDY

CASE STUDY: MCDONALDS MARKETING STRATEGIES

McDonald's is the world's largest fast-food restaurant chain. It has more than 30,000 restaurants in over 100 countries. Over one billion more customers were served in 2007 than in 2006. Although net income was down by $1.1 billion in 2007, McDonald's sales were up 6.8%, and revenue was a record high of $23 billion. "The unique business relationship among the company, its franchisees and suppliers (collectively referred to as the System) has been key to McDonald's success over the years. The business model enables McDonald's to play an integral role in the communities we serve and consistently deliver relevant restaurant experiences to customers.".

McDonald's overall strategic plan is called Plan to Win. Their focus is not so much on being the biggest fast-food restaurant chain, rather it is more focused on being the best fast-food restaurant chain. McDonald's "strategic alignment behind this plan has created better McDonald's experiences through the execution of multiple initiatives surrounding the five factors of exceptional customer experiences — people, products, place, price and promotion". McDonald's also incorporates geographical strategic plans. In the U.S., McDonald's strategic plan continues to focus on breakfast, chicken, beverages and convenience. These are the core areas in the United States. McDonald's has launched the Southern Style Chicken Biscuit for breakfast and the Southern Style Chicken Sandwich for lunch and dinner. In the beverage business, McDonald's starting introducing new hot specialty coffee offerings on a market-by-market basis. In Europe, McDonald's uses a tiered menu approach. This menu features premium selections, classic menu, and everyday affordable offerings. They also "complement these with new products and limited-time food promotions". In the Asia-Pacific, Middle East, and Africa markets, McDonald's strategic plan is focused around convenience, breakfast, core menu extensions and value. With McDonald's overall strategic plan and its geographical strategic plan, the company should start to see more positive financial results.

McDonald's incorporates several organizational strategies. Some of the organizational strategies consist of better restaurant operations, placing the customer first, menu variety and beverage choice, convenience and daypart expansion, and ongoing restaurant reinvestment. McDonald's plans to "continue to drive success in 2008 and beyond by leveraging key consumer insights and our global experience, while relying on our strengths in developing, testing and implementing initiatives surrounding our global business drivers of convenience, branded affordability, daypart expansion and menu variety". One of the ways McDonald's can obtain a positive net income is to maximize efficiency in its restaurant operations while at the same time placing the customer first. With strategic focus on menu variety and beverage choice, McDonald's is hoping for increased sales and guest counts. With their convenience and daypart expansion initiative, McDonald's is hoping to increase efficiency in its drive-thru pick up window, and the company is staying open later for those late-nighters who want a quick bite to eat. McDonald's also has locally owned and operated restaurants which "are at the core of their competitive advantage and makes them not just a global brand but a locally relevant one". They are in the process of remodeling and upgrading its franchises. The company is also opening up McCafe's "with the expectation that the gourmet coffee shop would move it closer to its goal of doubling sales at existing U.S. restaurants over the next decade". A couple other organizational strategies are branded affordability, and the development of their employees starting with recruitment and training and leading all the up to leadership and management.

McDonald's strategic plan is influencing their marketing efforts by building better brand transparency. They want their image to be recognized globally. They are enhancing the customer's experience. "Across their markets, they are making is easier for customers to enjoy a great McDonald's experience. They are introducing drive-thrus to the increasingly mobile populations in China and Russia, while in the U.S. and Canada, greater drive-thru efficiency and double drive-thru lanes enable them to serve even more customers quickly" (McDonald's, 2008, 13). In Germany, McDonald's has a reimaging program that includes adding about 100 McCafes. They are also installing new kitchen operating systems so that they can continue to deliver high food quality. McDonald's has already renovated about 10,000 restaurants world wide. They want their restaurants to be an expression of their brand. The company is also delivering greater value to the customer with new menu selections. "By serving a locally relevant balance of new products, premium salads and sandwiches, classic menu favorites and everyday affordable offerings around the world, they create value for customers and satisfy their demand for choice and variety" (McDonald's, 15).

Types of marketing mix that McDonald's use to achieve their marketing goals are longer operating hours, everyday value meals, and optimizing efficiency in the drive-thru. McDonald's also uses marketing campaigns. In 2007, McDonald's used the Shrek movie to give children a choice between milk, fruit, or vegetables as part of their Happy Meal. In addition to their commitment with children, McDonald's is building their brand image "with innovated marketing transporting ideas across borders and using i'm lovin' it to deepen their connection with customers who love their food and the unique McDonald's experience" (McDonald's, 2008, 17). In the 2008 Olympics held in Beijing, McDonalds offered the Beijing Burger, Carmel and Banana Sundae, and Rice Sticks. They featured nine Olympic and Paralympic athletes on their packaging. In Australia, McDonald's held a marketing campaign where the people could decide what name to give its new hamburger. The name that won was Backyard Burger. With marketing campaigns like these, McDonald's is trying to create a better brand image.

Other organizational and marketing strategies are "creating stronger bonds of trust by being accessible and maintaining an open dialogue with customers and key stakeholders" (McDonald's, 2008, 27). The company is reinvesting approximately $1.9 billion into their restaurants primarily to reimage existing restaurants and build new ones. McDonald's is also moving towards a more heavily franchised, less capital-intensive business model. Although in some countries, such as China, this is not permissible due to governmental laws.

With McDonald's growing global brand image and its emphasis on the five factors of exceptional customer service, this should help them increase sales and net income. With the initiative of remodeling and upgrading existing franchises, this will give the customer a more pleasant and friendly place to dine out at. With McDonald's marketing campaign for the 2008 Olympics, they were an integral part of the games and this only enhanced McDonald's brand image in a positive way. With the recruitment and training initiatives for current employees or future prospects, this will allow McDonald's to achieve less of an already high turnover ratio.

SUMMARY

- An income statement is one of the three important financial statements used for reporting a company's financial performance over a specific accounting period, with the other two key statements being the balance sheet and the statement of cash flows.
- The income statement can be prepared in one of two methods. The Single Step income statement totals revenues and subtracts expenses to find the bottom line. The Multi-Step income statement takes several steps to find the bottom line: starting with the gross profit, then calculating operating expenses.
- A basic income statement represents a snapshot of the restaurant's performance for a specific period, which is usually a calendar month or a 30-day period.
- Accounts receivable and payable, assets, liabilities, and retained earnings, as shown on a balance sheet, would help provide the true value of the business, or what it would be worth if all outstanding monies came in, all debts were paid, and all assets were converted to cash.
- A profit and loss statement; also called an income statement, lists the revenues and expenses of a business during a given period and give a restaurant owner the bottom line on whether it is making money.
- Revenue is one half of the profit and loss statement. For a restaurant, it will be all of the sales on food, beverages, catering and merchandise.
- Gross profit isn't a restaurant's bottom line. To get that, other expenses must be considered. Payroll costs, including commissions paid, are likely to be the next biggest expense for a restaurant.
- Restaurants are businesses with high overhead costs and a high potential for waste. The two largest expense categories are labor and food and beverage.
- A restaurant's marketing expenses include everything it does to get guests to come and eat food in the restaurant. One of the most important marketing tools is the menu, as it will dictate many of the other expenses a restaurant has.

MULTIPLE CHOICE QUESTIONS

1. **The statement of operations is also known as**
   a. The cash flow statement.
   b. The statement of retained earnings.
   c. The owner's equity statement.
   d. The balance sheet.
   e. The income statement.
2. **For a restaurant, food costs are considered**
   a. A gain.
   b. A direct expense.
   c. A loss.
   d. An indirect expense.
   e. An indirect cost.
3. **For a hotel, depreciation expense is considered**
   a. A gain.
   b. A direct cost.
   c. An indirect cost.
   d. A direct expense.
   e. A loss.
4. **Which of the following costs is an indirect cost?**
   a. Salaries and wages
   b. Food costs
   c. Beverage costs
   d. Repair and maintenance costs
   e. Employee benefits costs
5. **Which of the following items is not an undistributed operating expense?**
   a. Food department salaries and wages
   b. Marketing expenses
   c. Human resources expenses
   d. Property operation and maintenance expenses
   e. Security expenses

Review Questions

1. How to manage expenses for a restaurant business?
2. How to evaluate the average profit margin for a restaurant?
3. Who uses an income statement for a restaurant?
4. What are the read and write phenomena of an income statement?
5. How do you create a restaurant profit and loss statement?

Answer to Multiple Choice Questions

1. (e) 2. (b) 3. (c) 4. (d) 5. (a)

REFERENCES

1. Berman, B. (2005). Applying yield management pricing to your service business. Business Horizon, 48(2), 169-179.
2. Chiang, W. C., Chen, J. C. H., & Xu, X. (2007). An overview of research on revenue management: Current issues and future research. International journal of revenue management, 1(1), 97-128.
3. Choi, S., & Mattila, A. S. (2004). Hotel revenue management and its impact on customer fairness perceptions. Journal of Revenue and Pricing Management, 2(4), 303-314.
4. Choi, S., & Mattila, A. S. (2005). Impact of information on customer fairness perceptions of hotel revenue management. Cornell Hotel and Restaurant Administration Quarterly, 46(4), 27-35.
5. Dickson, D., Ford R. C., & Laval, B. (2005). Managing real and virtual waits in hospitality and service organizations. Cornell Hotel and Restaurant Administration Quarterly, 46(1), 52-68.
6. Susskind, A. M., Reynolds, D., & Tsuchiya, E. (2004). An evaluation of guests' preferred incentives to shift time-variable demand in restaurants. Cornell Hotel and Restaurant Administration Quarterly, 45(1), 68-84.

CHAPTER

5

CASH FLOW

"The more a business owner knows about their cash flow, the more empowered they become."

- Nick Chandi,

INTRODUCTION

Cash flow refers to the inflow and outflow of the amount of cash or its equivalents in business. It determines the amount of cash consumed or generated for a specified period. Its analysis also identifies the existing sources of the flow of cash along with a possible scope of inflows. The current flow of cash for a given period is identified by reducing the opening balance of a given period from its closing balance.

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

1. Discuss the basic concept of cash flow
2. Explain the statement of cash flows
3. Focus on funds flow statement
4. Explain the financial statement and cash flow
5. Define the common size statement

Once calculated, cash flows can result in a negative or positive balance. A positive balance implies that the company has sufficient cash to fulfil its immediate liquidity requirements, while a negative balance indicates a constricted liquidity. The cash flow of a company must, however, be analyzed along with the company's income statement as well as a balance sheet to determine its actual liquidity position.

Cash flow is the net amount of cash and cash equivalents being transferred into and out of a business. Cash received represents inflows, while money spent represents outflows. At a fundamental level, a company's ability to create value for shareholders is determined by its ability to generate positive cash flows or, more specifically, maximize long-term free cash flow (FCF). FCF is the cash that a company generates from its normal business operations after subtracting any money spent on capital expenditures (CapEx).

A business takes in money from sales as revenues and spends money on expenses. A company may also receive income from interest, investments, royalties, and licensing agreements and sell products on credit, expecting to actually receive the cash owed at a late date. Assessing the amounts, timing, and uncertainty of cash flows, along with where they originate and where they go, is one of the most important objectives of financial reporting. It is essential for assessing a company's liquidity, flexibility, and overall financial performance.

Positive cash flow indicates that a company's liquid assets are increasing, enabling it to cover obligations, reinvest in its business, return money to shareholders, pay expenses, and provide a buffer against future financial challenges. Companies with strong financial flexibility can take advantage of profitable investments. They also fare better in downturns, by avoiding the costs of financial distress.

Cash flows can be analyzed using the cash flow statement, a standard financial statement that reports on a company's sources and usage of cash over a specified time period.

5.1 BASIC CONCEPT OF CASH FLOW

Cash flow is the net amount of cash that an entity receives and disburses during a period of time. A positive level of cash flow must be maintained for an entity to remain in business, while positive cash flows are also needed to generate value for investors. The time period over which cash flow is tracked is usually a standard reporting period, such as a month, quarter, or year. Cash inflows come from the following sources:

- *Operations*. This is cash paid by customers for services or goods provided by the entity.

- *Financing activities*. An example is debt incurred by the entity.
- *Investment activities*. An example is the gain on invested funds.

Cash outflows originate with the following sources:

- *Operations*. This is expenditures made as part of the ordinary course of operations, such as payroll, the cost of goods sold, rent, and utilities.
- *Financing activities*. Examples are interest and principal payments made by the entity, or the repurchase of company stock, or the issuance of dividends.
- *Investment activities*. Examples are payments made into investment vehicles, loans made to other entities, or the purchase of fixed assets.

An alternative way to calculate the cash flow of an entity is to add back all non-cash expenses (such as depreciation and amortization) to its net after-tax profit, though this approach only approximates actual cash flows.

Cash flow is not the same as the **profit** or loss recorded by a company under the accrual basis of accounting, since accruals for revenues and expenses, as well as for the delayed recognition of cash already received, can cause differences from cash flow.

A persistent, ongoing negative cash flow based on operational cash flows should be a cause of serious concern to the business owner, since it means that the business will require an additional infusion of funds to avoid bankruptcy.

A summary of the cash flows of an entity is formalized within the statement of cash flows, which is a required part of the financial statements under both the GAAP and IFRS accounting frameworks.

The amount of cash or cash-equivalent which the company receives or gives out by the way of payment(s) to creditors is known as cash flow. Cash flow analysis is often used to analyze the liquidity position of the company. It gives a snapshot of the amount of cash coming into the business, from where, and amount flowing out.

Keyword

Profit is a financial benefit that is realized when the amount of revenue gained from a business activity exceeds.

As discussed, cash flows can either be positive or negative. It is calculated by subtracting the cash balance at the beginning of a period which is also known as opening balance, form the cash balance at the end of the period (could be a month, quarter or a year) or the closing balance.

If the difference is positive, it means you have more cash at the end of a given period. If the difference is negative it means that you have less amount of cash at the end of a given period when compared with the opening balance at the starting of a period.

To analyze where the cash is coming from and going out, cash flow statements are prepared. It has three main categories – operating cash flow which includes day-to-day transactions, investing cash flow which includes transactions which are done for expansion purpose, and financing cash flow which include transactions relating to the amount of dividend paid out to stockholders.

However, the level of cash flow is not an ideal metric to analyze a company when making an investment decision. A Company's balance sheet as well as income statements should be studied carefully to come to a conclusion.

Cash level might be increasing for a company because it might have sold some of its assets, but that doesn't mean the liquidity is improving. If the company has sold off some of its assets to pay off debt then this is a negative sign and should be investigated further for more clarification.

If the company is not reinvesting cash then this is also a negative sign because in that case it is not using the opportunity to diversify or build business for expansion.

A **cash flow** is a real or virtual movement of money:

- a cash flow in its narrow sense is a payment (in a currency), especially from one central bank account to another; the term 'cash flow' is mostly used to describe payments that are expected to happen in the future, are thus uncertain and therefore need to be forecast with cash flows;
- a cash flow is determined by its time t, nominal amount N, currency CCY and account A; symbolically $CF = CF(t, N, CCY, A)$.
- it is however popular to use *cash flow* in a less specified sense describing (symbolic) payments into or out of a business, project, or financial product.

Cash flows are narrowly interconnected with the concepts of value, interest rate and liquidity. A cash flow that shall happen on a future day t_N can be transformed into a cash flow of the same value in t_0.

5.1.1 What is Cash Flow?

Cash Flow (CF) is the increase or decrease in the amount of money a business, institution, or individual has. In finance, the term is used to describe the amount of cash (currency) that is generated or consumed in a given time period. There are many types of CF, with various important uses for running a business and performing financial analysis.

Cash flow is the money that is moving (flowing) in and out of your business in a month. Although it does sometimes seem that cash flow only goes one way—out of the business—it does flow both ways.

- Cash is coming in from customers or clients who are buying your products or services. If customers don't pay at the time of purchase, some of your cash flow is coming from collections of accounts receivable.
- Cash is going out of your business in the form of payments for expenses, like rent or a mortgage, in monthly loan payments, and in payments for taxes and other accounts payable.

5.1.2 Types of Cash Flow

Cash flows can be divided into three main categories depending on their source or utilization. They include the following –

- ***Flow of cash from operations***: It specifies the cash generated out of an entity's core business activities. When preparing a cash flow statement, cash inflows and outflows from operations are recorded in the first section. Cash inflow here mainly includes the money received after the sale of goods or services.

Outflows of cash from operations comprise operations expenditures such as rent payments, cost of goods sold, etc.

- ***Flow of cash from investments***: It represents any changes, i.e., increase or decrease in long term assets of a business. It can be represented by the purchase of fixed assets, any loans extended by the entity, any gains assumed on an investment fund and the likes.
- ***Flow of cash from financing activities***: Cash inflow or outflow from financing activities is recorded if an increment or reduction in the long term, debts, liabilities, business capital or dividend is observed. A cash flow example from financing activities would encompass principal or interest payments, stock repurchase, dividends issued, liabilities incurred, etc.

During cash flow analysis, the periodic balance calculated for these types of liquidity flows is subjected to various measurement parameters to identify the company's liquidity position and other financial aspects.

There are several types of Cash Flow, so it's important to have a solid understanding of what each of them is. When someone refers to CF, they could mean any of the types listed below, so be sure to clarify which cash flow term is being used. Types of cash flow include:

- ***Cash from Operating Activities*** – Cash that is generated by a company's core business activities – does not include CF from investing. This is found on the company's Statement of Cash Flows (the first section).
- ***Free Cash Flow to Equity (FCFE)*** – FCFE represents the cash that's available after reinvestment back into the business (capital expenditures).
- ***Free Cash Flow to the Firm (FCFF)*** – This is a measure that assumes a company has no leverage (debt). It is used in financial modeling and valuation.
- ***Net Change in Cash*** – The change in the amount of cash flow from one accounting period to the next. This is found at the bottom of the Cash Flow Statement.

5.1.3 Uses of Cash Flow

Cash Flow has many uses in both operating a business and in performing financial analysis. In fact, it's one of the most important metrics in all of finance and accounting.

The most common cash metrics and uses of CF are the following:

- ***Net Present Value*** – calculating the value of a business by building a DCF Model and calculating the net present value (NPV)

- ***Internal Rate of Return*** – determining the IRR an investor achieves for making an investment
- ***Liquidity*** – assessing how well a company can meet its short-term financial obligations
- ***Cash Flow Yield*** – measuring how much cash a business generates per share, relative to its share price, expressed as a percentage
- ***Cash Flow Per Share (CFPS)*** – cash from operating activities divided by the number of shares outstanding
- ***P/CF Ratio*** – the price of a stock divided by the CFPS (see above), sometimes used as an alternative to the Price-Earnings, or P/E, ratio
- ***Cash Conversion Ratio*** – the amount of time between when a business pays for its inventory (cost of goods sold) and receives payment from its customers is the cash conversion ratio
- ***Funding Gap*** – a measure of the shortfall a company has to overcome (how much more cash it needs)
- ***Dividend Payments*** – CF can be used to fund dividend payments to investors
- ***Capital Expenditures*** – CF can also be used to fund reinvestment and growth in the business

Cash flows of an entity can serve as an essential metric in the entirety of accounting and finance while also proving useful for day-to-day business operations. Not to mention, it has a key role to play in providing accuracy to financial analysis.

The following table illustrates the few uses a business's computed cash flow can be put to.

Cash flow utilization	**Description**
Business liquidity	It helps identify how efficient a business is in meeting its short-term financial obligations.
Yield per share	Represented in percentage, it is the measurement of cash generated by a business for each share it holds as against the existing share price.
Flow of cash per share	It measures the cash generated only from operating activities based on per share outstanding.
Gap in funding	Existing flow of cash identified also helps a company assess the difference between the cash available and the cash required.
Cash conversion ratio	It determines the time taken for a business to convert the initial investment made via inventory into cash through customer payment. Such a ratio can be tactfully utilized to formulate necessary cash flow strategies to bring business to its optimum operational efficiency.

While these were some of the common usages of computation of cash flow, the list is inclusive. Some of its other critical uses of cash flow analysis include calculation of the business's Net Present Value, funding available for reinvestment, business growth, dividend payment, etc.

5.1.4 Cash Flow vs Income

REMEMBER

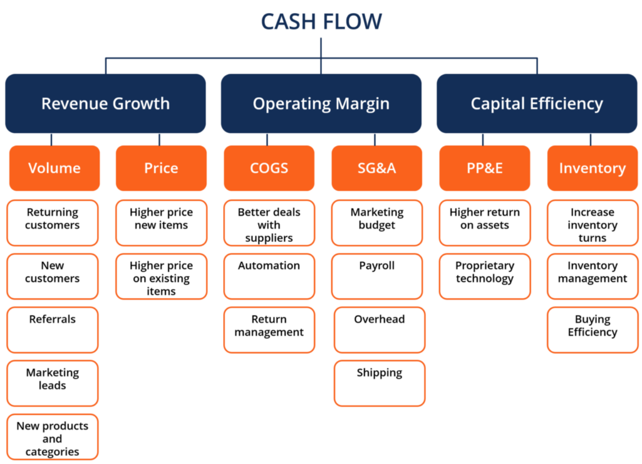
Due to revenue recognition policies and the matching principle, a company's net income, or net earnings, can actually be materially different from its Cash Flow.

Investors and business operators care deeply about CF because it's the lifeblood of a company. You may be wondering, "How is CF different from what's reported on a company's income statement?" Income and profit are based on accrual accounting principles, which smooths-out expenditures and matches revenues to the timing of when products/services are delivered.

Companies pay close attention to their CF and seek to manage it as carefully as possible. Professionals working in finance, accounting, and financial planning & analysis (FP&A) functions at a company spend significant time evaluating the flow of funds in the business and identifying potential problems.

5.1.5 Cash Flow Generation Strategies

Since CF matters so much, it's only natural that managers of businesses do everything in their power to increase it. Let's explore how operators of businesses can try to increase the flow of cash in a company. Below is an infographic that demonstrates how CF can be increased using different strategies.



Managers of business can increase CF using any of the levers listed above. The strategies for improving CF fall into one of three categories: revenue growth, operating margins, and capital efficiency. Each of those can then be broken down into higher volume, higher prices, lower cost of goods sold, lower SG&A, more efficient property plant & equipment (PP&E), and more efficient inventory management.

5.1.6 Cash Flow Analysis

Cash flows are often transformed into measures that give information e.g. on a company's value and situation:

- to determine a project's rate of return or value. The time of cash flows into and out of projects are used as inputs in financial models such as internal rate of return and net present value.
- to determine problems with a business's liquidity. Being profitable does not necessarily mean being liquid. A company can fail because of a shortage of cash even while profitable.
- as an alternative measure of a business's profits when it is believed that accrual accounting concepts do not represent economic realities. For instance, a company may be notionally profitable but generating little operational cash (as may be the case for a company that barters its products rather than selling for cash). In such a case, the company may be deriving additional operating cash by issuing shares or raising additional debt finance.
- cash flow can be used to evaluate the 'quality' of income generated by accrual accounting. When net income is composed of large non-cash items it is considered low quality.
- to evaluate the risks within a financial product, e.g., matching cash requirements, evaluating default risk, re-investment requirements, etc.

Cash flow notion is based loosely on cash flow statement accounting standards. The term is flexible and can refer to time intervals spanning over past-future. It can refer to the total of all flows involved or a subset of those flows.

Within cash flow analysis, 3 types of cash flow are present and used for the cash flow statement:

- [Operating cash flow] - a measure of the cash generated by a company's regular business operations. Operating cash flow indicates whether a company can produce sufficient cash flow to cover current expenses and pay debts.

- Cash flow from investing activities - the amount of cash generated from investing activities such as purchasing physical assets, investments in securities, or the sale of securities or assets.
- Cash flow from financing activities (CFF) - the net flows of cash that are used to fund the company. This includes transactions involving dividends, equity, and debt.

5.1.7 Business' Financials

The (total) net cash flow of a company over a period (typically a quarter, half year, or a full year) is equal to the change in cash balance over this period: positive if the cash balance increases (more cash becomes available), negative if the cash balance decreases. The total net cash flow for a project is the sum of cash flows that are classified in three areas:

- Operational cash flows: cash received or expended as a result of the company's internal business activities. Operating cash flow of a project is determined by:
  - OCF = incremental earnings + depreciation= (earning before interest and tax−tax)+ depreciation
  - OCF = earning before interest and tax*(1−tax rate)+ depreciation
  - OCF = (revenue − cost of good sold − operating expense − depreciation)* (1−tax rate)+depreciation
  - OCF = (Revenue − cost of good sold − operating expense)* (1−tax rate)+ depreciation* (tax rate)

Depreciation*(tax rate) which locates at the end of the formula is called depreciation shield through which we can see that there is a negative relation between depreciation and cash flow.

- Changing in net working capital: it is the cost or revenue related to the company's short-term asset like inventory.
- Capital spending: this is the cost or gain related to the company's fix asset such as the cash used to buy a new equipment or the cash which is gained from selling an old equipment.

The sum of the three component above will be the cash flow for a project.

And the cash flow for a company also include three parts:

- Operating cash flow: refers to the cash received or loss because of the internal activities of a company such as the cash received from sales revenue or the cash paid to the workers.

- Investment cash flow: refers to the cash flow which related to the company's fixed assets such as equipment building and so on such as the cash used to buy a new equipment or a building
- Financing cash flow: cash flow from a company's financing activities like issuing stock or paying dividends.

The sum of the three components above will be the total cash flow of a company.

5.1.8 Impact of Weak Cash Flow Management

Given that cash flow is a critical metric that determines a business's liquidity, financial position and flexibility in operation, weak management in the flow of cash can take it through severe risk, along with creating other long and short-term impacts.

- ***Increase in inventory*:** Businesses often stock up the inventory to fulfil high demand from the market. Nevertheless, a sudden change in such demand can leave the inventories indisposed, thus strapping sizable cash, further creating operational challenges.
- ***Long payment cycle*:** Allowing your creditors a long cycle for payment can mean cash invested in raw material for an extended duration, creating a strain on other financial aspects. It is thus critical to decide on the payment cycle that keeps cash flow from operations at optimum.
- ***Overspending*:** Acquiring a new client or getting a high-volume order can push one towards spending more than they can afford. Nevertheless, in the absence of actual cash, it would only mean an added burden on the short-term liquidity sustenance for the business.

Difference between Cash Flow and Income

The primary point of difference between a business's cash flow and its income is defined by the cash accounting and accrual accounting measures undertaken.

The adoption of these two separate methods primarily results in the difference between an income statement and a cash flow statement.

In the preparation of an income statement, the method of accrual accounting is followed, wherein an income or expenditure is recorded as and when it occurs, irrespective of the involvement of cash.

In the latter, however, transactions are recorded only when they have been dealt in cash and not merely based on accrual.

Difference between Cash Flow and Revenue

In the case of revenue, it is only a measure of the amount of money a business is receiving, whereas cash flow involves a two-way flow.

Thus, in it, both inflow and outflow of cash are considered for the purpose of calculation. Also, revenue is strictly based on the conversion of investment made to business operations while cash flows also take into consideration financing activities.

Steps for Cash Flow Management

To ensure that a business has an optimum flow of cash, undertaking the following measures are advised –

- Maintain proper bookkeeping records with the in-time entry of all cash transactions made.
- Companies can keep the tracking and analysis of cash inflow and outflow from different sources through cash flow statement preparations on a quarterly basis.
- Analyse the statement to decide on whether to free up cash or introduce additional cash to the business.
- Identify areas that involve overspending and cut down on such spends to increase the flow of cash in a business.

Apart from these, various other measures can be undertaken to bring an entity's cash flow to an optimum level.

Cash flows serve as a quintessential measure of a business's profitability, strength, and its overall outlook in the long term. A business must, therefore, take necessary steps to maintain the flow of cash for various periods based on structured analysis and results so obtained.

5.2 STATEMENT OF CASH FLOWS

A cash-flow statement is a document prepared by a company that details how much money is flowing in and out of the business. Specifically, it shows the change in cash and cash equivalents in a given period of time. Along with an income statement, most small businesses prepare a cash-flow statement at least every quarter. Some may even prepare one every month. While a cash-flow statement is a requirement for publicly listed companies, non-listed companies still use them for keeping track of payments. Many hire an accountant familiar with GAAP accounting rules and standards to prepare a cash-flow statement.

In business accounting, non-cash transactions include any items that do not directly involve the transfer of money. When preparing a cash-flow statement, the only way to adjust for non-cash transactions is through the indirect method, which subtracts rule items from the company's net income. For larger businesses that often deal with non-cash transactions, preparing a cash-flow statement using the indirect method is important as it gives a more accurate description of the company's current finances.

The statement of cash flows contains information about the flows of cash into and out of a company; in particular, it shows the extent of those activities that generate and use cash. This statement comprises part of the financial statements, though its importance has historically been considered less than the income statement and balance sheet.

The statement of cash flows is quite useful for revealing the existence of cash flows that are not readily apparent from the results listed in the income statement.

Expenditures may have been made for items classified as assets, so these expenditures do not appear in the income statement, but will appear in the statement of cash flows. Because of the disparity in results, it is entirely reasonable to review the income statement and statement of cash flows together, to gain a proper perspective on any differences between reported financial results and the related cash flows

The primary activities listed in the statement of cash flows are:

- Operating activities are an entity's primary revenue-producing activities. Examples of operating activities are cash receipts from the sale of goods, as well as from royalties and commissions, amounts received or paid to settle lawsuits, fines, payments to employees and suppliers, cash payments to lenders for interest, contributions to charity, and the settlement of asset retirement obligations.
- Investing activities involve the acquisition and disposal of long-term assets. Examples of investing activities are

cash receipts from the sale of property, the sale of debt or equity instruments of other entities, and repayment of loans made to other entities. Examples of cash payments that are investment activities include the acquisition of property, plant, and equipment, and purchases of the debt or equity of other entities.

- Financing activities are those activities resulting in alterations to the amount of contributed equity and the entity's borrowings. Examples of financing activities include cash receipts from the sale of the entity's own equity instruments or from issuing debt, proceeds received from derivative instruments, as well as cash payments to buy back shares, pay dividends, and to pay off outstanding debt.

The statement of cash flows also incorporates the concept of cash and cash equivalents. A cash equivalent is a short-term, very liquid investment that is easily convertible into a known amount of cash, and which so is near its maturity that it presents an insignificant risk of changes in value because of changes in interest rates.

We can use the direct method or the indirect method to present the statement of cash flows. The direct method presents the specific cash flows associated with items that affect cash flow.

- Cash collected from customers
- Interest and dividends received
- Cash paid to employees
- Cash paid to suppliers
- Interest paid
- Income taxes paid

Under the indirect method, the presentation begins with net income or loss, with subsequent additions to or deductions from that amount for non-cash revenue and expense items, resulting in net cash provided by operating activities.

There are three critical parts of a company's financial statements: the balance sheet, the income statement, and the cash flow statement. The balance sheet gives a one-time snapshot of a company's assets and liabilities. The income statement indicates the business's profitability during a certain period.

The cash flow statement differs from the other financial statements because it acts as a corporate checkbook that reconciles the other two statements. The cash flow statement records the company's cash transactions (the inflows and outflows) during the given period. It shows whether all of the revenues booked on the income statement have been collected.

At the same time, however, the cash flow does not necessarily show all the company's expenses because not all expenses the company accrues are paid right away. Although the company may have incurred liabilities, any payments toward these liabilities are not recorded as a cash outflow until the transaction occurs.

The first item to note on the cash flow statement is the bottom line item. This is likely to be the "net increase/decrease in cash and cash equivalents (CCE)." The bottom line reports the overall change in the company's cash and its equivalents (the assets that can be immediately converted into cash) over the last period. If you check under current assets on the balance sheet, you will find CCE. If you take the difference between the current CCE and that of the previous year or the previous quarter, you should have the same number as the number at the bottom of the statement of cash flows.

5.2.1 Various Cash and Non-cash Transactions

A cash-flow statement, and non-cash transaction encompasses any aspect that undergoes depreciation or amortization. These includes transactions such as the conversion of bonds to other types of assets or vice versa, lease arrangements that lead to a purchase, such as commercial real estate rentals, and the exchange of any asset for another asset that is not cash. Items such as interest rate payments are not non-cash transactions. Although non-cash transactions do not normally appear on a cash-flow statement, an accountant can adjust a cash-flow statement to factor in such transactions. To do this, an accountant uses the indirect method of creating a cash-flow statement.

Indirect Method of Cash-flow Statement Preparation

There are two main methods for constructing a cash-flow statement: the direct and indirect method. The former simply sums up all cash transactions, from both customers and investment activities and adds and subtracts any interest or dividends the company is liable for. The accountant, using this information, then computes the cash flow for the company for the end of the year. The indirect method, on the other hand, computes the end of year cash flow by adding up net income and rule items. The accountant obtains net income from the company's income statement. Rule items include all non-cash transactions.

Example

Consider a company with a net income of $100,000 a year. The accountant adjusts net income upward for the following non-cash transactions: $2,000 for depreciation, $1,000 for the amortization of bond discounts, $1,000 for the loss on sale of equipment, $1,000 for the decreases in accounts receivable and $1,000 for the increase in accounts payable. This increases net income to $106,000. The accountant then adjusts net income downwards for the following items: $3,000 for the amortization of bond premiums, $2,000 for the gain on the sale of equipment and $3,000 for the increase in taxes payable. This brings net income down to $98,000, which is equal to the company's end-of-year cash flow.

5.2.2 Preparations of Cash Flow Statement and its Analysis

Cash flow analysis is a method of analyzing the financing, investing, and operating activities of a company. The primary goal of cash flow analysis is to identify, in a timely manner, cash flow problems as well as cash flow opportunities. The primary document used in cash flow analysis is the cash flow statement. The Securities and Exchange Commission (SEC) has required every company that files reports to include a cash flow statement with its quarterly and annual reports. The cash flow statement is useful to managers, lenders, and investors because it translates the earnings reported on the income statements which are subject to reporting regulations and accounting decisions to a simple summary of how much cash the company has generated during the period in question. "Cash flow measures real money flowing into, or out of, a company's bank account," Harry Domash notes on his Web site, WinningInvesting.com. "Unlike reported earnings, there is little a company can do to overstate its bank balance."

The Cash Flow Statement

A typical cash flow statement is divided into three parts: cash from operations (from daily business activities like collecting payments from customers or making payments to suppliers and employees); cash from investment activities (the purchase or sale of assets); and cash from financing activities (the issuing of stock or borrowing of funds). The final total shows the net increase or decrease in cash for the period.

Cash flow statements facilitate decision making by providing a basis for judgments concerning the profitability, financial condition, and financial management of a company. While historical cash flow statements facilitate the systematic evaluation of past cash flows, projected cash flow statements provide insights regarding future cash flows. Projected cash flow statements are typically developed using historical cash flow data modified for anticipated changes in price, volume, interest rates, and so on.

To enhance evaluation, a properly-prepared cash flow statement distinguishes between recurring and nonrecurring cash flows. *For example*, collection of cash from customers is a recurring activity in the normal course of operations, whereas collections of cash proceeds from secured bank loans (or issuances of stock, or transfers of personal assets to the company) is typically not considered a recurring activity. Similarly, cash payments to vendors is a recurring activity, whereas repayments of secured bank loans (or the purchase of certain investments or capital assets) is typically not considered a recurring activity in the normal course of operations.

In contrast to nonrecurring cash inflows or outflows, most recurring cash inflows or outflows occur (often frequently) within each cash cycle (i.e., within the average time horizon of the cash cycle). The cash cycle (also known as the operating cycle or the earnings cycle) is the series of transactions or economic events in a given company whereby:

1. Cash is converted into goods and services.
2. Goods and services are sold to customers.
3. Cash is collected from customers.

To a large degree, the volatility of the individual cash inflows and outflows within the cash cycle will dictate the working-capital requirements of a company. Working capital generally refers to the average level of unrestricted cash required by a company to ensure that all stakeholders are paid on a timely basis. In most cases, working capital can be monitored through the use of a cash budget.

The Cash Budget

In contrast to cash flow statements, cash budgets provide much more timely information regarding cash inflows and outflows. *For example*, whereas cash flow statements are often prepared on a monthly, quarterly, or annual basis, cash budgets are often prepared on a daily, weekly, or monthly basis. Thus, cash budgets may be said to be prepared on a continuous rolling basis (*for example*, are updated every month for the next twelve months). Additionally, cash budgets provide much more detailed information than cash flow statements. *For example*, cash budgets will typically distinguish between cash collections from credit customers and cash collections from cash customers.

A thorough understanding of company operations is necessary to reasonably assure that the nature and timing of cash inflows and outflows is properly reflected in the cash budget. Such an understanding becomes increasingly important as the precision of the cash budget increases. *For example*, a 360-day rolling budget requires a greater knowledge of a company than a two-month rolling budget.

While cash budgets are primarily concerned with operational issues, there may be strategic issues that need to be considered before preparing the cash budget. *For example*, predetermined cash amounts may be earmarked for the acquisition of certain investments or capital assets, or for the liquidation of certain indebtedness. Further, there may be policy issues that need to be considered prior to preparing a cash budget. *For example*, should excess cash, if any, be invested in certificates of deposit or in some form of short-term marketable securities.

Generally speaking, the cash budget is grounded in the overall projected cash requirements of a company for a given period. In turn, the overall projected cash requirements are grounded in the overall projected free cash flow. Free cash flow is defined as net cash flow from operations less the following three items:

1. Cash used by essential investing activities (*for example*, replacements of critical capital assets).
2. Scheduled repayments of debt.
3. Normal dividend payments.

If the calculated amount of free cash flow is positive, this amount represents the cash available to invest in new lines of business, retire additional debt, and/or increase dividends. If the calculated amount of free cash flow is negative, this amount represents the amount of cash that must be borrowed (and/or obtained through sales of nonessential assets, etc.) in order to support the strategic goals of the company. To a large degree, the free cash flow paradigm parallels the cash flow statement.

Using the overall projected cash flow requirements of a company (in conjunction with the free cash flow paradigm), detailed budgets are developed for the selected time interval within the overall time horizon of the budget (i.e., the annual budget could be developed on a daily, weekly, or monthly basis). Typically, the complexity of the company's operations will dictate the level of detail required for the cash budget. Similarly, the complexity of the corporate operations will drive the number of assumptions and estimation algorithms required to properly prepare a budget (e.g., credit customers are assumed to remit cash as follows: 50% in the month of sale; 30% in the month after sale. Several basic concepts germane to all cash budgets are:

- Current period beginning cash balances plus current period cash inflows less current period cash outflows equals current period ending cash balances.
- The current period ending cash balance equals the new period's beginning cash balance.
- The current period ending cash balance signals either a cash flow opportunity (*for example*, possible investment of idle cash) or a cash flow problem (*for example*, the need to borrow cash or adjust one or more of the cash budget items giving rise to the borrow signal).

5.2.3 Ratio Analysis

In addition to cash flow statements and cash budgets, ratio analysis can also be employed as an effective cash flow analysis technique. Ratios often provide insights regarding the relationship of two numbers (*for example*, net cash provided from operations versus capital expenditures) that would not be readily apparent from the mere inspection of the individual numerator or denominator. Additionally, ratios facilitate comparisons with similar ratios of prior years of the same company (i.e., intercompany comparisons) as well as comparisons of other companies (i.e., intercompany or industry comparisons). While ratio analysis may be used in conjunction with the cash flow statement and/or the cash budget, ratio analysis is often used as a stand-alone, attention-directing, or monitoring technique.

Additional Benefits

Dick Levin suggests the following benefits that stem from cash forecasting (i.e., preparing a projected cash flow statement or cash budget):

1. Knowing what the cash position of the company is and what it is likely to be avoids embarrassment. *For example*, it helps avoid having to lie that the check is in the mail.

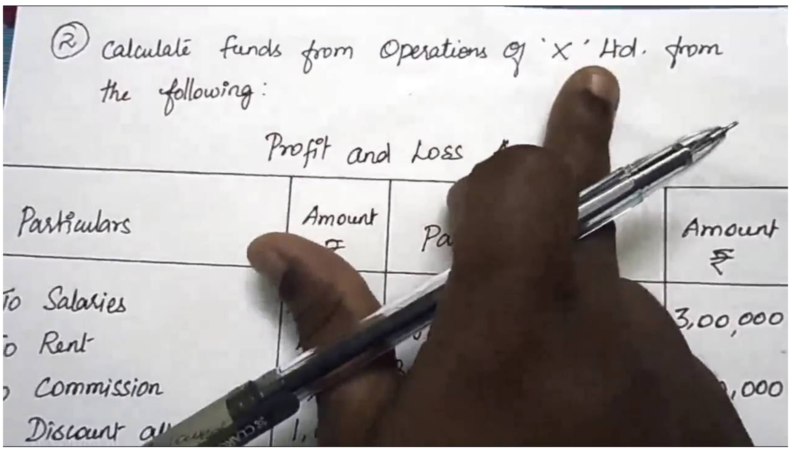
2. A firm that understands its cash position can borrow exactly what it needs and no more, thereby minimizing interest or, if applicable, the firm can invest its idle cash.
3. Walking into the bank with a cash flow analysis impresses loan officers.
4. Cash flow analyses deter surprises by enabling proactive cash flow strategies.
5. Cash flow analysis ensures that a company does not have to bounce a check before it realizes, it needs to borrow money to cover expenses. In contrast, if the cash flow analysis indicates that a loan will be needed several months from now; the firm can turn down the first two offers of terms and have time for further negotiations.

Keyword

Working Capital is a financial metric which represents operating liquidity available to a business, organization or other entity, including governmental entity.

5.3 FUNDS FLOW STATEMENT

The funds flow statement is the earlier version of the statement of cash flows that is now required to report changes in an entity's cash flows during an accounting period. The funds flow statement was required under GAAP from the period 1971 through 1987. The funds flow statement primarily reported changes in an entity's net working capital position between the beginning and end of an accounting period. Net **working capital** is an entity's current assets minus its current liabilities**.**

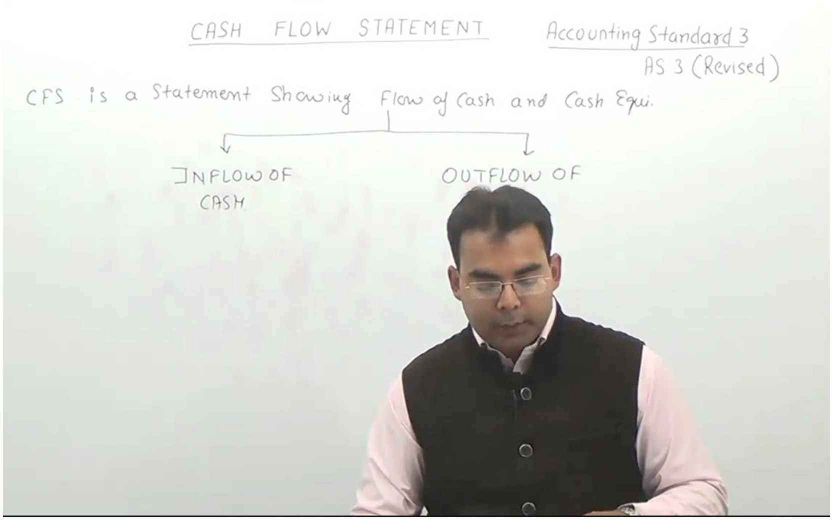


5.3.1 Cash Flow Statement Direct Method

The direct method of presenting the statement of cash flows presents the specific cash flows associated with items that affect cash flow. Items typically affecting cash flow include:

1. Cash collected from customers
2. Interest and dividends received
3. Cash paid to employees
4. Cash paid to suppliers
5. Interest paid
6. Income taxes paid

The advantage of the direct method over the indirect method is that it reveals operating cash receipts and payments. However, the method is rarely used because few organizations aggregate cash flow information in the manner required reporting under the direct method. The indirect method is much more frequently used, because it can be derived directly from typical accounting reports.



Statement of Cash Flows Direct Method Example

Maria Machining Company constructs the following statement of cash flows using the direct method:

5.3.2 Cash Flow Statement Indirect Method

Under the indirect method of presenting the statement of cash flows, the presentation begins with net income or loss, with subsequent additions to or deductions from that amount for non-cash revenue and expense items, resulting in net cash provided by operating activities.

For example, XYZ Construction Company constructs the following statement of cash flows using the indirect method:

XYZ Construction Company

Statement of Cash Flows for the year ended 12/31/2014

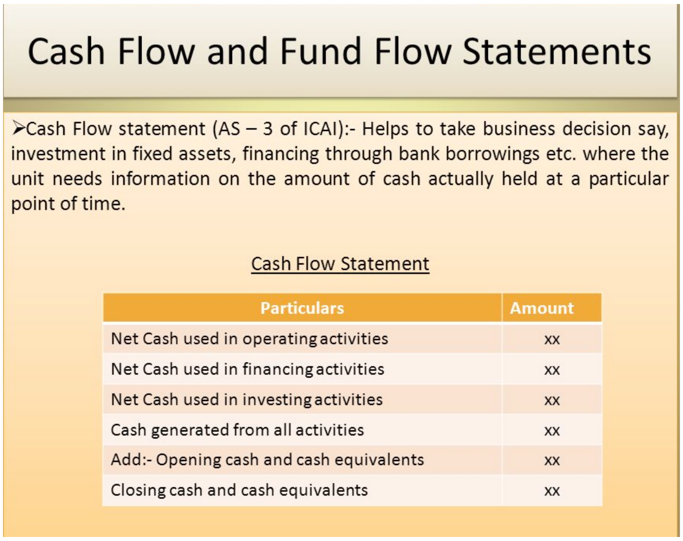
Cash flow from operating activities		
Net income		$30,00,000
Adjustments for:		
Depreciation and amortization	$1,25,000	
Provision for losses on accounts receivable	20,000	
Gain on sale of facility	(65,000)	
Increase in trade receivables	(2,50,000)	
Decrease in inventories	3,25,000	
Decrease in trade payables	(50,000)	
Cash generated from operations		
Cash flow from investing activities		31,05,000
Purchase of property, plant, and equipments	(5,00,000)	
Proceeds from sale of equipments	35,000	

Net cash used in investing activities		(4,65,000)
Cash flow from financing activities		
Proceeds from issue of common stock	1,50,000	
Proceeds from issuance of long-term debt	1,75,000	
Dividends paid	(45,000)	
Net cash used in financing activities		2,80,000
Net increase in cash and cash equivalents		29,20,000
Cash and cash equivalents at beginning of period		20,80,000
Cash and cash equivalents at end of period		$50,00,000
		80,000
		25,000

How to Prepare a Cash Flow Statement

A statement of cash flows contains information about the flows of cash into and out of a company, and the uses to which the cash is put. The statement of cash flows is part of the financial statements, and as such is heavily reviewed by the users of the financial statements.

The most commonly used format for the statement of **cash flows** is called the indirect method. The general layout of an indirect method statement of cash flows is shown are:



Cash Flow and Fund Flow Statements

➢Cash Flow statement (AS – 3 of ICAI):- Helps to take business decision say, investment in fixed assets, financing through bank borrowings etc. where the unit needs information on the amount of cash actually held at a particular point of time.

Cash Flow Statement

Particulars	Amount
Net Cash used in operating activities	xx
Net Cash used in financing activities	xx
Net Cash used in investing activities	xx
Cash generated from all activities	xx
Add:- Opening cash and cash equivalents	xx
Closing cash and cash equivalents	xx

5.3.3 Preparation of Funds Flow Statement

Generally a fund is interpreted as working capital. Thus, funds flow is change in working capital. Hence, the changes in working capital is called as flow, the flow may be inflow or outflow. The term working capital has two concepts, gross working capital and net working capital. Gross working capital is the total of all current assets, whereas net working capital is the excess of current assets over current liabilities. Fund flow statement is prepared and interpreted on the basis of net working capital concept. Funds flow statement measures and presents in an analytical manner the summarized version of the numerous flows of funds for a specified period.

Fund Transactions

There is a plenty of business transactions which results in flow of funds or which cause changes in working capital. For this purpose, all the business transactions classified into (a) those transactions which increase funds i.e. sources of funds (b) those transactions which decrease funds i.e. application of funds. Identification of transactions causing for increase or decrease in funds is essential for funds flow statement analysis. The following transactions do not affect the flow of funds. These are:

1. Transactions between two current assets
2. Transactions between two current liabilities
3. Transactions between current assets and current liabilities
4. Transactions between two non-current or fixed assets
5. Transactions between two long-term liabilities

6. Transactions between non-current assets and long-term liabilities

Transactions between a current account (non-current account) and another current account (non-current account) does not affect flow of funds. The first three is connected with current account; the last three belongs to non-current account. As against this concept, any transaction between a current account and a non-current account affect funds. These are:

1. Transaction between a long term liability and a current asset
2. Transaction between a long term liability and a current liability
3. Transaction between a non-current asset and a current asset
4. Transaction between a non-current asset and a current liability

Importance of Funds Flow Statement

Funds flow statement is an important tool, us helps in the planning, deployment and controlling of funds year after year. The following are the benefits of funds flow statement.

1. It provides a detailed analysis and understanding of changes between two balance sheet dates.
2. It shows the fund mobilization and canalization.
3. It helps to take fund projections for the future.
4. It is a useful technique to measure the quantum funds needs for efficient operation of a firm.

Distinction between Cash flow Statement and Funds Flow Statement

Basis Of Difference	Cash Flow	Funds Flow
Basis of Accounting	It recognizes Cash basis Of accounting	It is based upon accrual Basis of accounting I.e Working capital
Significance	It is useful for short-Term financial planning	It is useful for long-term Financial planning
Schedule of Changes in Working Capital	Such a schedule is not Prepared for preparing Cash flow statement	Schedule of changes in Working capital is Prepared separately
Causes of Variation	It studies only the Causes of cash variation	It studies causes of Change in working capital

Preparation of Funds Flow Statement and its Analysis

- However, the technique of cash flow statement when used in conjunction with ratio analysis serves as barometer in measuring the profitability and financial position of the business. The preparation of fund flow statement has the following steps:
- Schedule of changes in working capital
- Fund flow Statement

Schedule of Changes in Working Capital

It can be prepared by comparing the current assets and current liability of two periods.

Items	**As On**	**As On**	**Change**
Current Assets	Increase	Decrease	
Cash Balance			
Bank Balance			
Marketable Securities			
Accounts Receivables			
Accounts Receivables			
Stock-in-trades			
Prepaid Expenses			
Current liability			
Bank Overdraft			
Outstanding Expenses			
Account Payable			

Net increase/decrease in working capital			

Rules for Preparing the Schedule:

- An increase in current assets results in increase in working capital.
- Decrease in current assets result in decrease in working capital.
- Increase in a current liability results in decrease of working capital.
- Decrease in a current liabilities results in increase in working capital.

Source of Funds: Issue of shares Issue of debenture Long term borrowing Sale of fixed assets Operating profits Total Sources Application of funds: Redemption of redeemable preference shares Redemption of debentures Payment of other long term loans Purchase of fixed assets Operating Loss Operating Loss Total uses	
Net increase/Decrease in working capital (Total Source-Total Uses)	

5.4 FINANCIAL STATEMENT AND CASH FLOW

The massive amount of numbers in a company's financial statements can be bewildering and intimidating to many investors. On the other hand, if you know how to analyze them, the financial statements are a gold mine of information.

Financial statements are the medium by which a company discloses information concerning its financial performance. Followers of fundamental analysis use the quantitative information gleaned from financial statements to make investment decisions. Before we jump into the specifics of the three most important financial statements income statements, balance sheets and cash flow statements we will briefly introduce each financial statement's specific function, along with where they can be found.

The information provided in the financial statements is of immense use in making decisions through analysis and interpretation of financial statements.

Tools and Techniques of Financial Statement Analysis:

- Horizontal analysis
- Vertical analysis

5.4.1 Ratio Analysis

Ratio analysis is a financial technique that involves dividing various financial statement numbers into one another. Ratios are computed by dividing one amount on the financial statements into another. They are percentages that are easily obtained by entering the numbers from financial data into a calculator. The ratios can then be examined to determine, trends and reasons for changes in the financial statement from month to month. Ratios are valuable tools, as they standardize balance sheet and income statement numbers. A firm with \$10 billion in sales can be easily compared to a firm with \$1 billion or \$200 million in sales.

Three basic categories of ratio analysis are used.

- ***Trend or Time Series Analysis***: uses ratios to evaluate a firm's performance over time.
- ***Cross Section Analysis***: uses ratios to compare different companies at the same point in time.
- ***Industry Comparative Analysis***: is used to compare a firm's ratios against average ratios for other companies in the same industry.

Comparing a firm's ratios to average industry ratios requires a degree of caution. That is because some sources of industry data report the average for each ratio, others report the median, others report the inter quartile range for each ratio, which is the range for the middle 50% of ratio values reported by firms in the industry. The analyst must also be aware that industry ratios may be narrowly focused on a specific industry, but the operations of large firms such as GE, Exxon Mobil, and IBM often cross many industry boundaries. Also, accounting standards often differ among firms in an industry. This can create confusion, particularly when some firms in the industry adopt new accounting standards set forth by the financial accounting standards Board (FASB) before others. Adopting standards early can affect a firm's ratios by making them appear unusually high or low compared to the industry average. Care also must be taken when comparing different types of firms in the same industry. In one industry there may be a mixture of very large and very small firms, multinational and domestic companies that operate nationally as opposed to those that focus only on limited geographic markets. Analysts and sources of public information on ratios may compute ratios differently.

Keyword

Financial Ratio is a relative magnitude of two selected numerical values taken from an enterprise's financial statements.

Some may use after tax earnings, some pretax earnings; others may assume debt refers only to long term debt while others include all liabilities as debt. Therefore, when comparing ratios make sure we know how a resource defines its ratios before using it. Sometimes how a ratio is interpreted depends on who has requested it that is; whether a ratio appears favorable or unfavorable depends on the perspective Analysts and sources of public information on ratios may compute ratios differently. Some may use after tax earnings, some pretax earnings; others may assume debt refers only to long term debt while others include all liabilities as debt. Therefore, when comparing ratios make sure we know how a resource defines its ratios before using it. Sometimes how a ratio is interpreted depends on who has requested it that is, whether a ratio appears favorable or unfavorable depends on the perspective of the user. Therefore, the analyst must keep in mind the viewpoint of the user in evaluating and interpreting the information contained in **financial ratio**s.

5.4.2 Advantages of Ratios Analysis

Ratio analysis is an important and age old technique of financial analysis. The following are some of the advantages or Benefits of ratio analysis:

Simplifies Financial Statements

It simplifies the comprehension of financial statements. Ratios tell the whole story of changes in the financial condition of the business.

Facilitates Inter Firm Comparison

It provides data for inter firm comparison. Ratios highlight the factors associated with successful and unsuccessful firm. They also reveal strong firms and weak firms, overvalued and undervalued firms.

Helps in Planning

It helps in planning and forecasting. Ratios can assist management, in its basic functions of forecasting (Planning, coordination, control and communications).

Makes Inter Firm Comparison Possible

Ratios analysis also makes possible comparison of the performance of different divisions of the firm. The ratios are helpful in deciding about their efficiency or otherwise in the past and likely performance in the future.

Help in Investment Decisions

It helps in investment decisions in the case of investors and lending decisions in the case of bankers etc.

5.4.3 Limitations of Ratios Analysis

The ratios analysis is one of the most powerful tools of financial management though ratios are simple to calculate and easy to understand, they suffer from serious limitations.

Limitations of Financial Statements

Ratios are based only on the information which has been recorded in the financial statements. Financial statements themselves are subject to several limitations. Thus ratios derived, there from, are also subject to those limitations.

For example, non-financial changes though important for the business are not relevant by the financial statements. Financial statements are affected to a very great extent by accounting conventions and concepts.

Comparative Study Required

Ratios are useful in judging the efficiency of the business only when they are compared with past results of the business. However, such a comparison only provide glimpse of the past performance and forecasts for future may not prove correct since several other factors like market conditions, management policies, etc. may affect the future operations.

Ratios Alone are not adequate

Ratios are only indicators; they cannot be taken as final regarding good or bad financial position of the business. Other things have also to be seen.

Problems of Price Level Changes

A change in price level can affect the validity of ratios calculated for different time periods. In such a case the ratio analysis may not clearly indicate the trend in solvency and profitability of the company. The financial statements, therefore, be adjusted keeping in view the price level changes if a meaningful comparison is to be made through accounting ratios.

Lack of Adequate Standard

No fixed standard can be laid down for ideal ratios. There are no well accepted standards or rule of thumb for all ratios which can be accepted as norm. It renders interpretation of the ratios difficult.

Limited Use of Single Ratios

A single ratio, usually, does not convey much of a sense. To make a better interpretation, a number of ratios have to be calculated which is likely to confuse the analyst than help him in making any good decision.

Personal Bias

Ratios are only means of financial analysis and not an end in itself. Ratios have to interpret and different people may interpret the same ratio in different way.

Incomparable

Not only industries differ in their nature, but also the firms of the similar business widely differ in their size and accounting procedures etc. It makes comparison of ratios difficult and misleading.

5.4.4 Solvency Ratios

One of many ratios used to measure a company's ability to meet its long term obligations. The solvency ratio measures the size of a company's after tax income, excluding noncash depreciation expenses, compared with the firm's total debt obligations. It provides a measurement of how likely it is a company can continue to meet its debt obligations.

$$\frac{\text{Net income}}{\text{Share Holder Equity}}$$

A measure of a company's ability to service debts, expressed as a percentage. It is calculating by adding the company's post tax net profit and depreciation, and dividing the sum by the quantity of long term and short term liabilities, the resulting amount is expressed as a percentage. A high solvency ratio indicates a healthy company, while a low ratio indicates the opposite. A low solvency ratio further indicates likelihood of default. Different industries have different standards as to what qualifies as an acceptable solvency ratio, but, in general, a ratio of 20% or higher is considered healthy. Potential lenders may take the solvency ratio into account when considering making further loans.

Solvency ratios measure the financial soundness of a business and how well the company can satisfy its short and long term obligations:

Quick Ratio

This ratio, also called "acid test" or "liquid" ratio, considers only cash, marketable securities (cash equivalents) and accounts receivable because they are considered to be the most liquid forms of current assets. A Quick Ratio less than 1.0 implies dependency on inventory and other current assets to liquidate short term debt. This ratio is calculated using the following formula:

Cash + Accounts Receivable ÷ Current Liabilities

Current Ratio

This ratio is a comparison of current assets to current liabilities, commonly used as a measure of short run solvency, i.e., the immediate ability of a business to pay its current debts as they come due. Potential creditors use this ratio to measure a company's liquidity or ability to pay off short term debts. This traitor is calculated using the following formula:

Current Assets ÷ Current Liabilities

This ratio indicates the amount due creditors within a year as a percentage of the owners or stockholders investment. The smaller the net worth and the larger the liabilities, the less security for creditors. Normally a business starts to have trouble when this relationship exceeds 80%. This ratio is calculated using the following formula:

Current Liabilities ÷ Net Worth

Current Liabilities to Inventory Ratio

His ratio shows, as a percentage, the reliance on available inventory for payment of debt (how much a company relies on funds from disposal of unsold inventories to meet its current debt). This ratio is calculated using the following formula:

Current Liabilities ÷ Inventory

Total Liabilities to Net worth Ratio

This ratio shows how all of a company's debt relates to the equity of the owners or stockholders. The higher this ratio, the less protection there is for the creditors of the business. This ratio is calculated using the following formula:

Total Liabilities ÷ Net Worth

Fixed Assets to Net worth Ratio

This ratio shows the percentage of assets cantered in fixed assets compared to total equity. Generally the higher this percentage is over 75%, the more vulnerable a concern becomes to unexpected hazards and business climate changes. Capital is frozen in the form of machinery and the margin for operating funds becomes too narrow for day to day operations. This ratio is calculated using the following formula:

Fixed Assets ÷ Net Worth

5.4.5 Profitability Ratios

Any ratio that measures a company's ability to generate cash flow relative to some metric, often the amount invested in the company. Profitability ratios are useful in fundamental analysis which investigates the financial health of companies. An example of a profitability ratio is the return on investment which is the amount of revenue an investment generates as a percentage of the amount of capital invested over a given period of time. Other examples include return on sales, return on equity, and return on common stock equity. Some examples of profitability ratios are profit margin, return on assets, and return on equity. It is important to note that one should understand the company and its business before making decisions that are based solely on ratios. For instance, some industries are seasonal, such as retailers, which typically experience higher revenues and earnings during the holiday season. Therefore, it would not be helpful to compare a retailer's fourth quarter profit margin with its first quarter profit margin. In contrast, comparing a retailer's fourth quarter profit margin with the profit margin from the same period a year before would be far more helpful.

Related terms:

- Operating Profit
- Profit Margin
- Return on Assets ROA
- Return on Equity ROE

Operating Profit

The profit earned from a firm's core business operations. It does not include profit earned from the firm's investments (such as earnings from firms in which the company has a partial interest) and the effects of interest and taxes. Also known as earnings before interest and taxes (EBIT). It is calculated as shown here.

Operating profit= Operating Revenue - Operating Expenses

For example, ABC Printing Company earns $50 million from its core printing related operations, $10 million from its 40% stake in XYZ Corp., and $3.5 million from interest earned in its money market and bank accounts. In addition, the company spends $10 million in production related costs. Overall, the company's operating profit is $40 million. This is calculated by subtracting the $10 million in production costs from the $50 million in operating revenue. The other $10 million and $3.5 million in earnings are not included in operating income because they are investment income.

Profit Margin

A ratio of profitability calculated as net income divided by revenues or net profits divided by sales. It measures the dollar amount of the sales that a company actually retains in earnings. Profit margin is very useful in comparing companies in similar industries. A higher profit margin indicates a more profitable company. Profit margin is displayed as a percentage, a 20% profit margin, *for example*, means that the company has a net income of $0.20 for each dollar of sales. A company's earnings do not always tell the entire story. Increased earnings are good, but an increase does not mean that the profit margin of a company is improving. For instance, if a company's costs are rising at a faster pace than are sales, this will lead to a lower profit margin, indicating that the company should rein in its costs. Consider a company that has net income of $10 million from sales of $100 million, giving it a profit margin of 10% ($10 million/$100 million). If in the next year net income rises to $15 million on sales of $200 million, the company's profit margin will fall to 7.5%. Although the company has increased its net income, it has done so with diminishing profit margins.

Return on Assets

An indicator of how profitable a company is relative to its total assets. ROA provides an idea of how efficient management is at using its assets to generate earnings. It is calculated, as shown here, by dividing a company's annual earnings by its total assets, with ROA displayed as a percentage. Sometimes this is referred to as return on investment.

$$\frac{\text{Net income}}{\text{Total Assests}}$$

Note some investors add interest expense back into net income when performing this calculation because they would like to use operating returns before the cost of borrowing. ROA shows earnings that are generated from invested capital (assets). ROA for public companies can vary substantially and is industry specific. Thus, when one is using ROA as a comparative measure, it is best to compare it with a company's previous ROA numbers or the ROA of a similar company. A company's assets consist of both debt and equity, which are used to fund the operations of the company. ROA gives investors some idea of how effectively the company is converting the money it has into net income. The higher the ROA, the more a company earns on a smaller investment. *For example*, if one company has a net income of $1 million and total assets of $5 million, its ROA is 20%. If another company earns the same amount but has total assets of $10 million, it has an ROA of 10%. In this scenario, the first company is doing a better job of converting its investments into profit. When one thinks about it, this is management's ultimate job to make wise choices in allocating company resources. Anybody can make a profit by throwing a ton of money at a problem, but very few managers excel at making large profits with a small investment.

Return on Equity

A measure of a corporation's profitability, ROE reveals how much profit a company generates with the money shareholders have invested. It is calculated as shown here:

$$\frac{\text{Net income}}{\text{Share Holder Equity}}$$

The ROE is useful for comparing the profitability of a company with that of other firms in the same industry. There are several ways for investors to use ROE.

1. Investors want to see the return on common equity so they may modify the formula shown here by subtracting preferred dividends from net income and subtracting preferred equity for m shareholders' equity, giving the following

return on common equity (ROCE) = net income preferred dividends/common equity.

2. Return on equity also may be calculated by dividing net income by average shareholders' equity. Average shareholders' equity is calculated by adding shareholders' equity at the beginning of a period to shareholders' equity at the end of the period and dividing the result by 2.
3. Investors also can calculate the change in ROE for a period by using the shareholders' equity from the beginning of a period as a denominator to calculate the beginning ROE. Then the end of period shareholders' equity can be used as the denominator to calculate the ending ROE. Calculating both helps investors determine the change in profitability over the period.

5.4.6 Activity Ratios

Activity Ratios also known as efficiency or turn over ratios, measure how effectively the firm is using its assets. Some aspects of activity analysis are closely related to liquidity analysis. Our focus is to attention on how effectively the firm is managing two specific asset groups receivables and inventories and its total assets in genera they indicate the efficiency with which the capital employed is rotated in the business. The two factors on which overall profitability of the business depends are:

- The rate of return on capital employed.
- The turnover (the speed at which the capital employed in the business rotates).
- Higher the rate of rotation the greater the profitability.

Higher turnover means better use of capital or resources, which in turn means better profitability ratio.

Working Capital

Accounting ratios that measure a firm's ability to convert different accounts within their balance sheets into cash or sales. It depends upon the size and nature of business. Arithmetically it is the difference of Current Assets and Current Liabilities. Two companies with same working capital can have different current ratios. Similarly two companies may have same current ratio but different working capital.

Fixed Assets Turnover Ratio

It indicated whether investment in fixed assets has been judicious or not. The ratio is calculated as follows:

Working Capital=Current Assets-Current Liabilities

$$\frac{\text{Net Sales}}{\text{Net Fixed assets}}$$

A high ratio indicates efficient utilization of fixed assets.

5.4.7 Liquidity Ratios

A class of financial metrics that is used to determine a company's ability to pay off its short terms debts obligations. Generally, the higher the value of the ratio, the larger the margin of safety that the company possesses to cover short term debts. Common liquidity ratios include the current ratio, the quick ratio and the operating cash flow ratio. Different analysts consider different assets to be relevant in calculating liquidity. Some analysts will calculate only the sum of cash and equivalents divided by current liabilities because they feel that they are the most liquid assets, and would be the most likely to be used to cover short term debts in an emergency. A company's ability to turn short term assets into cash to cover debts is of the utmost importance when creditors are seeking payment. Bankruptcy analysts and mortgage originators frequently use the liquidity ratios to determine whether a company will be able to continue as a going concern.

Current Ratio

This is a way of testing liquidity by deriving the proportion of assets available to cover current liabilities, as follows:

Current ratio = Current assets ÷ Current liabilities

Current ratio is widely discussed in the financial world, and it is easy to understand. However, it can be misleading because the chances of a company ever needing to liquidate all its assets to meet liabilities are very slim indeed. It is often more useful to consider a company as a going concern, in which case we need to understand the time it takes to convert assets into cash, as well as the current ratio. A ratio of less than 1 (that is, where the current liabilities exceed the current assets) could mean that we are unable to meet debts as they fall due, in which case we are insolvent. A high current ratio could indicate that too much money is tied up in current assets *for example*, giving customers too much credit.

Cash Ratio

This indicates liquidity by measuring the amount of cash, cash equivalents, and invested funds that are available to meet current short term liabilities. It is calculated by using the following formula:

Cash ratio = (Cash + Cash equivalents + Invested funds) ÷ Current liabilities

The cash ratio is a more conservative measure of liquidity than the current ratio, because it only looks at assets that are already liquid, ignoring assets such as receivables or inventory.

Quick Ratio

The third liquidity ratio is a more sophisticated alternative to the current ratio, which measures the most liquid current assets excluding inventory but including accounts receivable and certain investments.

Quick ratio = (Cash equivalents + Short term investments + Accounts receivable) ÷ Current liabilities.

The quick ratio should be around 0.with very few companies having a cash ratio of over. To be absolutely safe, the quick ratio should be at least, which indicates that quick assets exceed current liabilities. If the current ratio is rising and the quick ratio is static, this suggests a potential stockholding problem.

Liquidity of Inventory

To help determined how effectively the firm is managing inventory (and also to gain an indication of the liquidity of inventory) we compute the inventory turnover ratio. This ratio, like other ratios, must be judged in relation to ratios of similar firms, the industry average or both Generally the higher the inventory turnover, the more efficient the inventory management of the firm and the "fresher" more liquid, the inventory and vice versa. It shows how quickly inventory is sold and is determined by Inventory Turnover Ratio (ITO). It is the number of times the company sells (turns over) it inventory during the year.

5.4.8 Market Capitalization Ratios

Market capitalization (MC) is calculated by multiplying the current market price (CMP) of a share by the total number of shares issued by the company (NS), with the formula:

MC = CMP x NS

Market capitalization represents the market value of a listed company and it reflects the public opinion on the net worth of the company, and it is a basic determinant in evaluation of shares. It does not always reflect the real worth of the company, as in case of take over and acquisition offers, when the company is assessed based on several factors that give value to its business. Market capitalization is one of the best liquidity indicators, it reveals how easily the company's shares can be traded, especially from the prospective of an investor who invested large amounts of money in shares and wished to know how easily a counterpart can be found if he wishes to sell said shares. This feature becomes extremely important when selecting the securities in a portfolio according to their market capitalization. From this point of view, companies are divided in three large categories large companies (large caps), medium companies (mid-caps), and small companies (small caps). Market capitalization is also the first indicator taken into consideration when the size of a stock exchange is in discussion, in which case it is referred to as the sum of market value (market capitalization) of all the companies listed on an organized market. Hence, market capitalization is one of the basic indicators characterizing a capital market.

$$\text{Long term Debt} = \frac{\text{Long termDebt}}{\text{Long Debt ShareholdersEquity}}$$

Market Capitalization is just a juggled name for a simple concept. It is the market value of outstanding shares of a company. The process of calculating the **market capitalization** involves multiplication of a company's outstanding shares by the existing market price of a single share, if ABC Company was trading at $20 per share and had a million shares outstanding, then the market capitalization would be calculated as ($20 X 1 million shares) which comes to $20 million.

Keyword

Market Capitalization is the total dollar market value of the shares outstanding of a publicly traded company; it is equal to the share price times the number of shares outstanding.

Types of Capitalization

Although there is one set of framework for delineating the various market caps. There are certain widely set standards for every capitalization.

The most important ones include:

- Mega cap including companies with a market cap of $200 and more.
- Big/large cap including companies featuring a market cap between $10 million $200 billion.
- Mid cap featuring companies with a market cap vitiating $2 $10 billion.

- Small cap includes generally new or comparatively young companies with a market cap ranging from $300 million to $2 billion.
- Micro cap includes penny stocks and denotes market cap between $50 million to $300 million.
- Nano cap includes companies featuring a market cap less than $50 million.

Importance of Market Capitalization

It is a general misconception that a higher stock price indicates a larger company. Stock price, might, however, misrepresent the actual worth of a company. The classification of companies into individual caps also allows investors to determine the growth vs. risk potential. Previously, the large caps have faced slower growth with lower risk. Conversely, small caps have faced higher growth potential with a higher risk level.

DID YOU KNOW ?

In 1863, the Dowlais Iron Company had recovered from a business slump, but had no cash to invest for a new blast furnace, despite having made a profit. To explain why there were no funds to invest, the manager made a new financial statement that was called a comparison balance sheet, which showed that the company was holding too much inventory.

5.5 COMMON SIZE STATEMENT

Common size analysis, as used in vertical analysis of financial statements, an item is used as a base value and all other accounts in the financial statement are compared to this base value. On the balance sheet, total assets equal 100% and each asset is stated as a percentage of total assets. Similarly, total liabilities and stockholder's equity are assigned 100%, with a given liability or equity account stated as a percentage of total liabilities and stockholder's equity. On the income statement, 100% is assigned to net sales, with all revenue and expense accounts then related to it in percentages. Expressing the items in proportion to some size related measure, standardized financial statements can be created, revealing trends and providing insight into how the different companies compare. The ratios often are expressed as percentages of the reference amount. Common size statements usually are prepared for the income statement and balance sheet, expressing information as follows:

5.5.1 Income Statement Items

An examination of Total's vertical common size income statement, Excise taxes declined steadily throughout the period, which increased net revenue available to the company. Whatever caused the decline in profit margin had to overcome this positive effect. Purchases offer a partial explanation. Rising crude oil prices hurt operating margins for the refining and retail businesses. However, while this expense grew substantially faster than sales during the three years (48.8% compared to net revenue growth of 39.2%) it does not account for the entire decline in net margins. Some expenses can be crucial to a company's future success. For example, pharmaceutical companies rely heavily on research and development. Improved margins due to lower R and D spending may actually be bad news. For oil companies, the equivalent of R and D is exploration costs – expenses related to trying to find new sources of oil. Total's exploration costs were fairly stable as a percentage of revenue. Another industry specific expense is depletion, which is the counterpart to exploration and the equivalent of depreciation for fixed assets. When new oil discoveries are made an estimate of the total available oil is added to assets. The depletion charge represents the amount used up each year from the resources. For forecasting future net margins, we would probably want to use the more recent years as a guideline. Tax rate increases should be considered permanent, and the 2004 net gain appears to have been a onetime event.

5.5.2 Balance Sheet Items

When reviewing common size balance sheets, particular attention should be paid to individual items that are not in line with this trend.

Limitations

As with financial statements in general, the interpretation of common size statements is subject to many of the limitations in the accounting data used to construct them.

For example:

- Different accounting policies may be used by different firms or within the same firm at different points in time. Adjustments should be made for such differences.
- Different firms may use different accounting calendars, so the accounting periods may not be directly comparable.

5.5.3 Comparative Balance Sheet

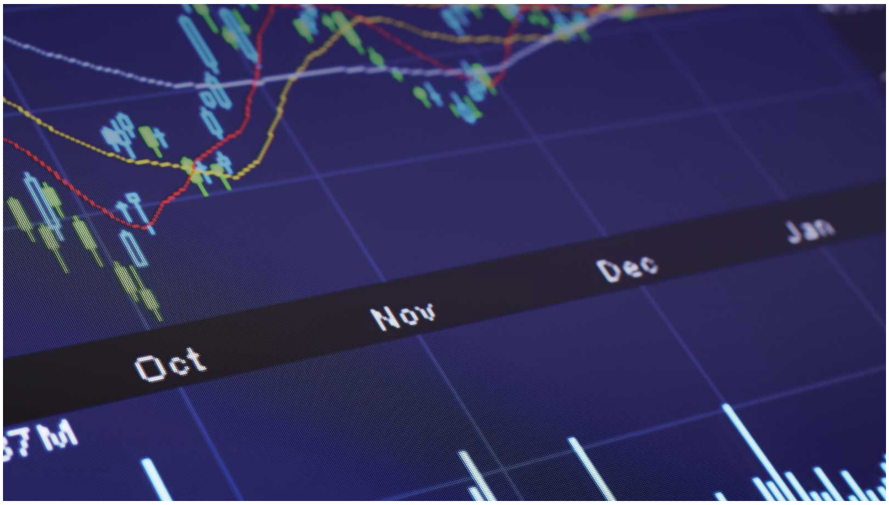
Comparative Financial Statement analysis provides information to assess the direction of change in the business. Financial statements are presented as on a particular date for a particular period. The financial statement Balance Sheet indicates the financial position as at the end of an accounting period and the financial statement. Income Statement shows the operating and non-operating results for a period. But financial managers and top management are also interested in knowing whether the business is moving in a favorable or an unfavorable direction. *For example*, if net income of a particular year has decreased from its previous year, despite an increase in sales during the year, is a matter of serious concern. Comparative financial statement analysis in such situations helps to find out where costs have increased which has resulted in lower net income than the previous year.

XYZ Company Comparative Balance Sheets		
Assets	**Year End 20012**	**Year End 20013**
Cash	$ 30,000	$ 35,500
Marketable Sec	10,000	10,000
Asset Rec	1,70,000	2,00,000
Inventory	1,60,000	180,000
Prepaid Exp	30,000	20,000
Investments	20,000	50,000

Plant and Equipment	10,00,000	11,00,000
Less Acc Depreciation	5,50,000	6,00,000
Net Plant and Equipment	4,50,000	5,00,000
Total Assets	8,70,000	9,95,500
Liabilities and Owner's Capital Accts Pay	45,000	80,000
ST Bank Loans	1,00,000	1,00,000
Accrued Exp	35,000	30,000
LT Bank Loans	40,000	90,000
Owners Capital	6,50,000	6,95,500
Total Liabilities and Capital	8,70,000	9,95,500

5.5.4 Trend Analysis of Manufacturing

Professionals track industry trends to make informed predictions, according to EconomyWatch.com. Someone with the ability to accurately recognize industry trends and correctly predict where an industry is heading unlocks immense potential for success as long as he is brave enough to act. Manufacturing companies have several different accounts compared to service and merchandising companies. These include three types of inventory accounts raw materials, work in process, and finished goods and several long term fixed asset accounts. A manufacturing company uses purchased raw materials and/or parts to produce a product for sale. At a point in time, the company's inventories consist of raw materials, those materials and parts waiting to be used in production, work in process, all material, labor, and other manufacturing costs accumulated to date for products not yet completed, and finished goods, the cost of completed products that are ready to be sold. The value of each type of inventory is disclosed in a company's financial statements. The amounts may be shown individually on the face of the balance sheet or disclosed in footnotes.



1. We can use data from the balance sheet, income statement and cash flow statement to perform a financial analysis of the company. There are 18 financial ratios which identify a company's liquidity, risk, efficiency and profitability.

Current Ratio = Current Assets ÷ Current Liabilities

A current ratio is considered good as it indicates the company has twice as many assets as liabilities and thus greater financial stability.

2. The higher the inventory turns, the faster the company sells its goods, decreases its warehousing costs and increases its cash flow.

Inventory Turnover = Cost of Goods Sold ÷ Inventory

3. A high accounts receivable turnover indicates that the company is able to receive cash from sales to its customers relatively quickly. More cash on hand enables the company to pay off debt on time and purchase additional assets when needed.

Accounts Receivable Turnover = Total Net Sales ÷ Accounts Receivable

4. The higher the gross profit margin, the more profit the company makes from its products. A gross profit margin of 80%, *for example*, indicates that for every $1.00 in sales, only .20 is actually spent to make the product sold

Gross Profit Margin = Gross Profit ÷ Total Sales

5. A lower debt to equity ratio indicates the company has less debt, is more financially stable and in a good position to obtain loans. A higher ratio carries a higher credit risk.

Debt to Equity Ratio = Total Liabilities ÷ Total Shareholders Equity

5.5.5 Service and Banking Organizations

The direct way in which an organization conununicates the product or service to its target audiences. Within the financial services industry, promotion is used in many different ways (Meidan). Brassington and Pettitt have categorized the promotional tools into five main elements:

1. Advertising
2. Sales Promotion
3. Public Relations
4. Personal Selling
5. Direct Marketing

REMEMBER

While a bank interested in promoting its brand name and its different services would use a brand advertising policy.

Advertising

Advertising as any paid form of non-personal communication directed towards target audiences and transmitted through various mass media in order to promote and present a product service or idea. The key difference between advertising and the other promotional tools is that it is impersonal and communicates with large numbers of people through paid media channels. A financial services organization can use its advertising for either its short term or its long term objectives. A bank attempting to generate a long term buildup of its name would use institutional advertising.

The institutional advertising consists of promotion of the firm's image as a whole, and promotion of the products offered, with extra emphasis on the specific firm's name organization. The organization seeks through its marketing conlinunications, to build awareness and to impress customers looking for the best range of financial services. Due to the former impression of banks as impersonal institutions with no interest in their customers as people, and of financial services as abstract and quite similar, the institutional advertising has become more and more important. Brand advertising follows closely in the footsteps of institutional advertising. Its purpose is to create awareness of the bank's name and to advertise the different services it is offering. Since financial firms are serving a mass of people, the problems of brand advertising are to know who to advertise to, and how to advertise. While institutional advertising is directed towards the whole population the brand advertising of particular products has to be much more selective, since it has to show that the consumer will benefit from the service. Furthermore, all the individual campaigns of brand advertising have to be compatible in tone and presentation, and match the image the bank has created through its institutional advertising.

Sales Promotion

Sales promotion is different tactical marketing techniques with mostly short-term incentives which are designed to add value to the product or service in order to achieve specific sales or marketing objectives. Furthermore, Meidan states that it has two distinctive qualities. Firstly, it provides a bargain chance". Since many sales promotion tools have an attention gaining quality that communicates an offer that will not be available again to purchase something special. The disadvantage, however, is that although they appeal to a wide range of buyers. Many customers tend to be fewer brands loyal in the long run. If sales promotions are used too frequently and carelessly, it could lead to insecure customers, wondering whether the service is reliable or reasonably priced.

Meidan indicates that due to the conflicting ideas concerning the benefits of sales promotions a financial service organization must base its decisions upon relevance and usefulness of sales promotion. As well as cost effectiveness. Peatti and Peatti claim that normally, coupons special offers and other forms of price manipulation are the dominant forms of sales promotion. However price based promotions are difficult and probably dangerous to use for financial service markets. This to the fact that the price setting of a financial service is already a difficult process and that consumers often see lower prices as a result of lower quality. Meidan states that sales promotion within financial services appears to be most effectively used in combination with advertising. The primary objectives with sales promotion within financial services are to attract new customers to increase the level of deposit accounts, thereby increasing the banks share of savings, to increase market share in selected market segments, and to lower the cost of acquiring new customers by seeking to avoid direct price competition with other financial institutions.

Public Relations

According to Brassington and Pettitt the essence of **public relations (PR)** is to look after the nature and quality of the relationship between the organization and its different publics, and to create a mutual understanding. PR covers a range of activities, for example the creation and maintenance of corporate identity and image, charitable involvement, such as sponsorship, and communication initiatives media relation for the spreading of good news, as well as for crisis management, such as damage limitation. Moreover, an organization can attend trade exhibitions to create stronger relationships with key suppliers and customers as well as enhancing the organization's presence and reputation within the market.

Meidan, states that another part of public relations is the publicity gained through magazines. Financial services obtain considerable publicity in so called quality press. Such as different financial journals.

Keyword

Public Relations (PR) is the practice of managing the spread of information between an individual or an organization and the public.

Personal Selling

Personal selling a two way communication tool between a representative of an organization and an individual or group. The intention to inform, persuade or remind them or sometimes serve them to take appropriate actions. Further more personal selling is a crucial element in ensuring customers' post purchase satisfaction, and in building profitable long term buyer seller relationships built on trust and understanding.

Direct Marketing

According to Brassington and Pettitt direct marketing is an interactive system of marketing. Using one or more advertising media to achieve measurable response anywhere. Forming a basis for creating and further developing an ongoing direct relationship between an organization and its customers. To be able to create and sustain quality relationships with sometimes hundreds or even thousands of individual customers. An organization needs to have as much information as possible about each one, and needs to be able to access, manipulate and analyze that information. Thus, the database is crucial to the process of building the relationship.

Lee states that the fast advances in technology over the past thirty years have reshaped how consumers today interact with their financial institutions. The financial sector has extended its "face to face" selling towards direct marketing of products and services in the form of phone, mail, or computer transactions.

Mol claims that as computer literacy and the availability of computers increase and the costs decrease Internet banking consumers are increasing considerably. Through the Internet banks the customers can identify interests. Furthermore the Internet technology also makes it possible to follow individual customer usage. With the information gathered in an integrated database it is possible to read the customer's needs and satisfy them.

SUMMARY

- Cash flow is the net amount of cash and cash equivalents being transferred into and out of a business. Cash received represents inflows, while money spent represents outflows.
- Since CF matters so much, it's only natural that managers of businesses do everything in their power to increase it.
- A cash-flow statement is a document prepared by a company that details how much money is flowing in and out of the business.
- Cash flow analysis is a method of analyzing the financing, investing, and operating activities of a company. The primary goal of cash flow analysis is to identify, in a timely manner, cash flow problems as well as cash flow opportunities.
- The funds flow statement is the earlier version of the statement of cash flows that is now required to report changes in an entity's cash flows during an accounting period.
- Financial statements are the medium by which a company discloses information concerning its financial performance.
- Ratio analysis is a financial technique that involves dividing various financial statement numbers into one another. Ratios are computed by dividing one amount on the financial statements into another.
- Market capitalization represents the market value of a listed company and it reflects the public opinion on the net worth of the company, and it is a basic determinant in evaluation of shares.
- An examination of Total's vertical common size income statement, Excise taxes declined steadily throughout the period, which increased net revenue available to the company. Whatever caused the decline in profit margin had to overcome this positive effect.
- Professionals track industry trends to make informed predictions, according to EconomyWatch.com. Someone with the ability to accurately recognize industry trends and correctly predict where an industry is heading unlocks immense potential for success as long as he is brave enough to act.

MULTIPLE CHOICE QUESTIONS

1. **Statement of cash flows includes**
   a. Financing Activities
   b. Operating Activities
   c. Investing Activities
   d. All of the Above
2. **In cash flows, when a company invests in fixed assets and short-term financial investments results in**
   a. Increased Equity
   b. Increased Liabilities
   c. Decreased Cash
   d. Increased Cash
3. **A company that issues stocks and bonds to raise funds results in**
   a. Decrease in Cash
   b. Increase in Cash
   c. Increase in Equity
   d. Increase in Liabilities
4. **The purchase value of assets over its serviceable life is categorized as**
   a. Appreciated Liabilities
   b. Appreciated Assets
   c. Depreciation
   d. Appreciation
5. **The basic financial statements include**
   a. Statement of Cash Flows
   b. Statement of Retained Earnings
   c. Balance Sheet and Income Statement
   d. All of the Above

Review Questions

1. What is cash flow?
2. Explain the types of cash flow.
3. Discuss about cash flow generation strategies
4. How to preparation of funds flow statement?
5. Define the ratio analysis.
6. Focus on income statement items and balance sheet items.

Answer to Multiple Choice Questions

1. (d) 2. (c) 3. (b) 4. (c) 5. (d)

REFERENCES

1. Auerbach, A. J., & Devereux, M. P. (2013). Consumption and cash-flow taxes in an international setting. STICERD - Public Economics Programme Discussion Papers 03, Suntory and Toyota International Centres for Economics and Related Disciplines, LSE. National Bureau of Economic Research.
2. Bodie, Zane; Alex Kane; Alan J. Marcus (2004). Essentials of Investments, 5th ed. McGraw-Hill Irwin.
3. Epstein, Barry J.; Eva K. Jermakowicz (2007). Interpretation and Application of International Financial Reporting Standards. John Wiley & Sons.
4. Watanabe, Izumi: The evolution of Income Accounting in Eighteenth and Nineteenth Century Britain, Osaka University of Economics, Vol.57, No. 5, January 2007, p.27-30.
5. Wild, John Paul. Fundamental Accounting Principles (18th ed.). New York: McGraw-Hill Companies. pp. 630–633.

CHAPTER

6

PRICING FOR PROFITS

"The moment you make a mistake in pricing, youre eating into your reputation or your profits."

- Katharine Paine

INTRODUCTION

The restaurant industry is not for the faint of heart. While passion is the spark that inspires restaurateurs to pursue their dreams, profit margins determine whether or not those dreams are a sustainable business. Unfortunately, profit margins are dwindling across the restaurant industry. Two decades ago in Philadelphia, for example, restaurant profit margins stood at a healthy 15-20%. Today, profit margins in this foodie town have shrunk to between 4 and 7%, which is on par with the national average.

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

1. Understand the art of pricing
2. Define the manager and menu pricing
3. Describe objective menu pricing methods

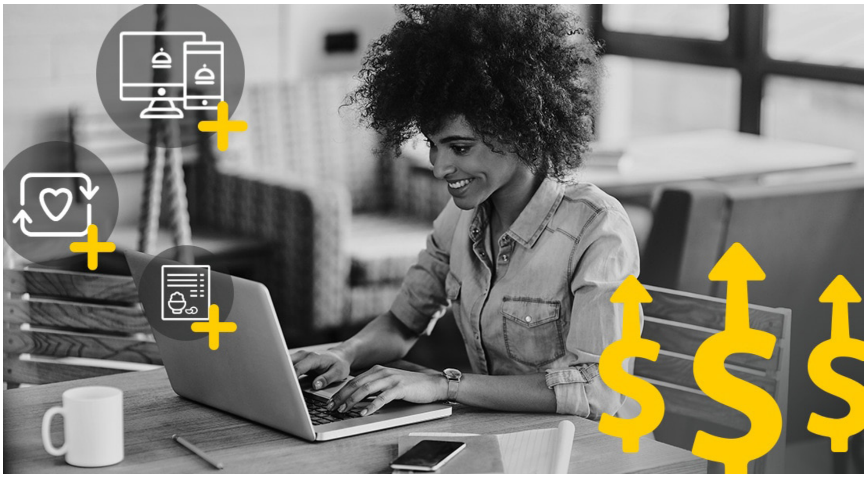
Keyword

Pricing is the process whereby a business sets the price at which it will sell its products and services, and may be part of the business's marketing plan.

How a restaurant owner or manager sets selling prices for food and beverage products will affect to what extent profit goals are met. If a price is too high, guests will perceive low value; complaints and reduced repeat business will be likely. If the selling price is too low, costs may not be recovered; profits will obviously suffer. Likewise, improper pricing that yields a lower-than-reasonable selling price can have a negative market impact; the public may reason "you can't get something for nothing" and question the quality, cleanliness, and service standards of the restaurant if prices are set too low. Specials that offer significant value can be an effective marketing tool. Taken to the extreme, however, consistently low selling prices can connote low value in spite of the manager's best intentions.

6.1 THE ART OF PRICING

Some experienced managers talk about the "art" of **pricing.** They are referring to the role that their intuition, knowledge of the guests' wants and needs, competition (its products and prices), and "having a feel for costs" play when pricing decisions are made. While these factors may be involved in the pricing decision at some point, managers must also be aware of their profit requirements and the costs associated with providing the products and services as selling prices are established. Those who only use an intuitive, subjective approach to pricing and neglect profit concerns run the risk of falling short of investors' expectations.



6.1.1 Subjective Pricing Methods

When a restaurant is well established, its pricing strategy is usually well developed. However, when costs escalate and guests' demand for "value" from the dining dollars they spend rises, the bottom line can suffer; to adapt to such changes, old methods of establishing selling prices must often be reexamined. The following pricing methods are used in many restaurants, but are probably best avoided:

- The "reasonable" price method. A manager using this method subjectively establishes selling prices based upon a personal belief about price levels that represent value for the guests. This emphasis is often ineffective; many managers do not know about their guests' real concerns; clearly, this approach does not relate to the profit requirements of the restaurant.
- The "highest price" method. Also based on the manager's perceived ability to "outguess the guest," this method suggests that selling prices be set as high as possible and then reduced slightly to allow for a margin of error in management's judgment about the guests' ability to pay.
- The loss-leader pricing method. With this tactic, the menu selling price for one or more items is set at the lowest possible price (even below cost) with the thought that guests will be attracted who will then purchase other products at regular (or even higher) prices. Managers using this approach think, for example, that "we will give away the food, and we'll make it up in beverage sales" (or vice versa).
- The intuitive pricing method. This approach actually involves little more than guessing about menu selling prices and then establishing other prices "if the first plan doesn't work."

- The "no pricing" method. This worst of all possible pricing practice is used all too often. When it is used, the service staff and cooks—not the managers—set selling prices. It occurs, for example, when menu substitutions are made and/or when menu items are prepared to special order. In the absence of a management-established price, prices are set as they are quoted to guests.

None of the above pricing methods incorporate profit requirements or even product costs into the pricing plan.

6.1.2 Costs And Pricing

Costs should be a central concern in any pricing decision. Accounting systems used by some restaurants do not identify all costs, and even if they do, they may not use an allocation process to spread overhead (indirect) costs between food and beverage departments. If costs are not accurately identified and allocated, information that might otherwise be available to managers cannot be used; decisions based upon poor information are often poor ones.

The pricing method used by a restaurant must incorporate both profit requirements and all costs. In contrast, the method used in many "real world" restaurants works as follows: A new food item is to be offered. The manager "determines" that a 40% food cost is necessary. If the cost of all ingredients in the new menu item is $3.15, a base selling price of $7.88 results [$3.15 × (100% ÷ 40%) = $7.88]. Since this "does not sound good," a more realistic price of $7.95 (or $8.25 or $8.55 or ?) results. How was the 40% food cost established? In the manager's mind, it may represent "the state or national average" or "what my food cost has been in the past" or simply "intuition." How are the restaurant's profit requirements and nonfood costs considered when this approach is used?

The pricing method used for the beverage department is often even more simplified. The manager “matches up” a drink item with one of the existing beverages categories offered to determine a selling price. For example, if a drink is a “highball” (one type of liquor with a mixer such as water, tonic, or soda) it sells for the same price as all other highballs. If a drink is a cocktail (martini, old fashioned, or manhattan), the cocktail price applies. Then beverage sales prices are gradually raised “when they need to be.” Beverage pricing for new facilities is often based only on competition or “what the market will bear.”

More objective pricing methods can be used that do incorporate required profit and product cost factors. Several modifying factors must be considered as these methods are used.

REMEMBER

Perceived value includes the entire dining experience: not only food and beverage products but also the restaurant’s atmosphere, location, service quality, level of sanitation/ cleanliness, and other, often intangible, factors.

Modifying Factors

When menu pricing is based on an objective cost approach, four modifying factors—historical prices, perceived price/ value relationships, competition, and price rounding—must be evaluated. These price modifiers relate to the pricing of nearly all products and services by the restaurant manager.

First, the restaurant’s past prices must be considered. A dramatic change dictated by a cost approach may seem unreasonable to guests. For example, if a breakfast currently priced at $3.49 needs to be raised to $5.49 to cover costs, the manager may need to move slowly, introducing several smaller price increases over a period of time.

Second, guests must perceive products/services to be reasonably priced to yield a good value. Today’s guests are increasingly value-conscious. Most are willing to pay higher prices than they did a few years ago, but they also demand value for the prices they pay.

Third, the competition cannot be ignored. If an operation’s product is viewed as substantially the same as a competitor’s, then everything else being equal, selling prices must be similar. For example, assume that a manager’s cost based calculations for a Caesar salad suggest a $6.50 selling price; if a strong, nearby competitor is charging $3.50 for a similar product, everything else being the same, then competition will probably force a price reduction. (Note: It is very difficult for everything else to be the same. The location is at least slightly different, one salad may be fresher, service may differ, etc. Effective managers attempt to differentiate their products/services from the competition to make them more favored by guests.)

Finally, the price may be modified by price rounding. That is, many managers round up calculated prices to the nearest $0.25 or, possibly, to $X.95.

Elasticity of Demand

One of the most important considerations in the pricing decision relates to the impact that selling prices have on sales volume. Often, restaurants that offer products at low prices are more dramatically affected by price increases than are their counterparts selling items at higher prices. When prices are low, guests often believe they are paying for the product itself—not the service, atmosphere, and other elements present in a more extensive "dining experience." Therefore, as selling prices increase, guests may believe that they are paying more for intangible aspects of the product/service/atmosphere mix being purchased; resistance may occur.

Conversely, the guest paying a higher price may not relate the price directly to the product being purchased. He/she may be less price-conscious than the guest in the low–selling price restaurant; the purchase decision may involve intangible (nonproduct) elements, the value of which is more difficult to quantify.

Elasticity is a term relating to the effects of selling-price increases or decreases on total revenues. Elastic demand describes a situation in which a reduction in selling price yields sales of enough additional units (meals or beverages) to increase total revenues, or a situation in which an increase in price yields lower sales, and therefore a decrease in total revenues. By contrast, inelastic demand describes the situation that occurs when a decrease in selling price leads to a decrease in total revenues, or when increased prices result in increased revenue.

The formula to measure elasticity of demand is:

$$\frac{\text{Change in quantity demanded} \div \text{Base quantity}}{\text{Change in price} \div \text{Initial price}}$$

The above formula looks complicated, but basically, when the calculation yields a number greater than 1, demand is elastic (total revenues increase when the unit selling price is decreased); when it is less than 1, demand is inelastic (total revenues decrease when the unit selling price is decreased). When the elasticity of demand is equal to

1, the price change produces no effect on total revenues. This is called unit elasticity.

Consider the following:

A menu item sells for \$6.95; 350 servings are sold during an average week. The manager lowers the selling price to \$6.25; 410 servings are sold weekly. What is the impact of the selling-price reduction on total revenues? What is the elasticity of demand?

The total change in revenues can be easily calculated:

Before price change:	350 servings at \$6.95 each	\$2,432.50
After price change:	410 servings at \$6.25 each	\$2,562.50

As a result of the decreased selling price, total revenue increased by \$130.00 (\$2,562.50 – \$2,432.50). There is elastic demand, as can be seen by the formula just presented:

$$\frac{\text{Change in quantity demanded} \div \text{Base quantity}}{\text{Change in price} \div \text{Initial price}}$$

$$\frac{(410 - 350) \div 350}{0.70 \div 6.95} = \frac{0.171}{0.101} = \underline{\underline{1.69}}$$

Note that the outcome is 1.69; we stated earlier that a result of 1.0 or greater means the demand is elastic (total revenues increase when the selling price is decreased).

Keyword

Menu pricing is the engine behind your company's success, as sales are your restaurant's sole source of revenue.

6.2 THE MANAGER AND MENU PRICING

Who should establish menu selling prices? Generally, responsibility for **menu pricing** should rest with the official who develops and implements the operating budget. As will be seen, profit requirements are included in the budget, and profit requirements should be carried forward to the pricing decision. In effect, then, a profit pricing approach should be used.

A restaurant's general manager may ultimately be responsible for attaining budget goals of the entire property. However, the food and beverage department heads both have an impact on revenues. Also, both these managers should control costs incurred by their departments. Therefore, each may be required to generate a mutually agreed upon part of the total profit requirement. Thus, department managers, working in conjunction with the general manager, may mutually establish selling prices for a given budget period.

The concept of integrated pricing should be noted. Food and beverage products generally should not be priced independently of each other. All products should be priced in a complementary manner so as to best ensure that the restaurant's total profit goals, including those of the specific departments, are attained. This principle can also be thought of as the concept of derived demand; sale of food (or beverage) products in one department is likely to affect activity in other departments. Consider, for example, the "spinoff" effects of increased drink sales in the lounge on food sales in the restaurant. As sales in one department increase (or decrease), a similar effect may carry over to the other department. The concepts of integrated pricing and desired demand again support the need for a management team approach when pricing decisions are made.

Subjective Pricing Procedures Should Be Avoided

The subjective pricing methods discussed earlier are understood by many in the restaurant industry and are simple to implement. However, they ignore the need to both identify and consider profit requirements and all costs, including direct food and beverage costs. When past operating percentages (from previous budgets) and current selling prices are used as the base from which to establish new prices, the manager assumes that past food/beverage operations were efficient and profit was optimized.

(Yet in fact, without proper analysis of required profit, there is not even certainty that profit was "satisfactory"!) If this assumption is incorrect (past operations were not optimally effective) these pricing methods, in effect, extend past operating problems into new fiscal periods.

Managers should recognize that profits are in part a function of sales. With fixed costs constant, total cost percentages are reduced as sales rise; higher profit levels result. In addition, larger purchases of food and beverages may result in quantity discounts: Economies of scale may result from lower per unit prices as higher quantities of product are purchased because of increased sales. There is, then, a need to correlate profit and costs with sales levels. Many common pricing methods fail to do this.

Managers who rely totally upon subjective methods to set selling prices often do not control their operation. They do not allow financial statements and accounting records to provide useful information about operations. By contrast, an effective pricing system incorporates management control information into pricing decisions. This, in turn, provides more internal consistency than do systems that yield autonomous, independent decisions about selling prices, incurred expenses, and profit expectations.

6.2.1 Profit Pricing: Pay Yourself First

Profit must be planned; costs must be identified and controlled. These standards should be incorporated into the pricing system used by the restaurant. These ideas can be combined into a single focal point if the manager merely regards profit as a "cost of doing business." Stated another way, revenue should be sufficient to cover all incurred costs, as well as to generate required profit. The manager should think about the following relationship:

Profit + Incurred Costs = Revenue

A useful pricing system must consider the profit needs of the owner/investor "up front" of incurred costs. This approach provides a different emphasis and perspective than does the following more traditional formula:

Revenue Incurred Costs = Profit

Any mathematician knows that the two formulas are the same; a good businessperson knows they are conceptually "worlds apart." Profit should not be "what's left after costs are subtracted from revenue." Managers should plan to, in effect, "pay themselves first" (generate profit) and then operate the restaurant effectively with remaining revenues without sacrificing quality requirements. One way to do this is to think about profit as a cost and build this cost (profit) into the selling price. Some refer to this approach as "bottom-up" pricing.

DID YOU KNOW ?

The concept of a lump-sum cost (menu cost) to changing the price was originally introduced by Sheshinski and Weiss (1977) in their paper looking at the effect of inflation on the frequency of price-changes.

6.2.2 Bottom-Up Pricing

A bottom-up method can be used to determine the average meal price for a restaurant. Seven steps in the process follow:

Step 1: Determine desired net income by multiplying the owners' investment by the desired return on owners' investment (ROI).

Step 2: Determine the pretax profit by dividing the desired net income by 1 minus the tax rate.

Step 3: Determine interest expenses.

Step 4: Determine operating expenses.

Step 5: Determine required food revenue by adding figures from Steps 2–4 and then dividing this sum by 1 minus the desired food cost percentage.

Step 6: Determine meals to be served by multiplying days open by number of seats by seat turnover for the day.

Step 7: Determine the required price of the average meal by dividing the total food revenue by the estimated number of meals to be served.

To illustrate the above process, let's look at Segee's Place. Applicable information is found in Figure 1.

Item	Amount	Other
Owners' investment	$ 500,000	Desired ROI = 12%
Funds borrowed	1,000,000	Interest rate = 10%
Tax rate	---	25%
Operating expenses	800,000	Annual amount
Cost of food sold percentage	---	40%
Seat turnover	---	2 times per day
Days open	---	365 days
Number of seats	---	100 seats

Figure 1. Factors to Assess Average Meal Price at Segee's Place.

Given this information we can calculate the average meal price needed to generate required profits.

Step 1: Determine Desired Net Income.

Owners' Investment × Desired ROI

$$\$500{,}000 \times 12\% = \$60{,}000$$

Step 2: Determine PreTax Profit.

$$\frac{\text{Net income}}{1 - \text{Tax rate}} = \frac{\$60{,}000}{1 - .25} = \$80{,}000$$

Step 3: Determine Interest Expense (funds borrowed).

$$\$1{,}000{,}000 \times .10 \times 1 = \$100{,}000$$

Step 4: Determine Operating Expenses.

$800,000 (Note: This was provided in Figure 1.)

Step 5: Determine Required Food Revenue.

$$\frac{\text{Pretax profit} + \text{Interest expense} + \text{Operating expenses}}{1 - \text{Food cost percentage}}$$

$$\frac{\$80{,}000 + \$100{,}000 + \$800{,}000}{1 - 40\%} = \$1{,}633{,}333$$

Step 6: Determine Meals to Be Served.

$$\text{Days open} \times \text{Number of seats} \times \text{Seat turnover}$$
$$365 \times 100 \text{ seats} \times 2 \text{ turns} = 73{,}000 \text{ meals}$$

Step 7: Determine Price of Average Meal.

$$\frac{\text{Total Revenue}}{\text{Total Meals}} = \frac{\$1{,}633{,}333}{73{,}000} = \$22.37$$

Keyword

Selling price is the amount a buyer pays for a product or service. The price can vary depending on how much buyers are willing to pay, how much the seller is willing to accept, and how competitive the price is in comparison to other businesses in the market.

The above calculations indicate an average per meal **selling price** of $22.37 will generate the level of revenue needed, first, to meet the owners' investment requirement (profits), and second, to meet costs required for interest and operating expenses (including cost of sales: food).

If management could turn the seats over faster (everything else being the same), the average meal price required to provide the owners with the desired 12% return on their investment would be reduced. For example, if the seat turnover could be increased to 3, then the average meal selling price would be:

$$\text{Average meal price} = \frac{\text{Food revenue}}{\text{Meals sold}} = \frac{\$1{,}633{,}333}{365 \times 100 \times 3} = \$14.92$$

By contrast, a less frequent seat turnover requires a higher average meal price if other factors are the same. For Segee's, a seat turnover of 1.5 would require an average meal price of $29.83.

Our discussion of the bottom-up approach to pricing meals has, to this point, centered on average meal prices. Few, if any, restaurants establish one price for all meals, and many restaurants offer meals at more than one meal period. For example, if the restaurant serves lunch and dinner, the average meal price for both meal periods can be calculated as follows:

- Calculate the revenue per meal period by multiplying the total food revenue by the estimated percentage of the total earned during that meal period.
- Divide the revenue per meal period by the meals sold per meal period. (The number of meals sold per meal period is calculated by multiplying the days the restaurant is open by the seat turnover by the number of seats.)

Once again, let's use Segee's to illustrate. Assume that management estimates the total food revenue to be divided between lunch and dinner revenue as 40% and 60%, respectively. Further, assume the luncheon seat turnover is 1.25 and the dinner seat turnover is 0.75. Using the total revenue for Segee's as calculated above, the average meal prices by meal period are:

Revenue Per Meal Period:

Lunch:	40% × \$1,633,333 =	\$ 653,333
Dinner:	60% × \$1,633,333 =	980,000
Total		\$1,633,333

Meals Sold Per Meal Period:

Lunch: $365 \times 100 \times 1.25 = \underline{\underline{45{,}625}}$

Dinner: $365 \times 100 \times 0.75 = \underline{\underline{27{,}375}}$

$$\textit{Average Meal Prices by Meal Period} = \frac{\text{Meal Period Revenue}}{\text{Meals Sold}}$$

$$\text{Lunch} = \frac{\$653{,}333}{45{,}625} = \underline{\underline{\$14.32}}$$

$$\text{Dinner} = \frac{\$980{,}000}{27{,}375} = \underline{\underline{\$35.80}}$$

example

Let's say Johnny's Burger Bar, a quick-service burger restaurant, has \$1.25 million in revenue, \$50,000 in gains, and \$1.2 million in expenses from July to September 2018.

Net profit = (1,250,000 + 50,000) – 1,200,000

Net profit = 100,000

Now that we have considered what the average per meal selling price must be for the restaurant to generate required profit and to have funds remaining to pay all other costs, let's look at some specific methods that incorporate price concerns into base selling prices.

6.2.3 Restaurant Menu Pricing Strategies To Maximize Restaurant Profit

we will take it to the next step and discuss some menu pricing strategies. Here we have rounded up the 'Top 9 Formulas And Strategies' to determine restaurant menu prices.

1. Price Your Menu According To The Type Of Restaurant

One of the most important, restaurant menu pricing strategies, before you decide the price of any dish on our restaurant menu, you must keep your restaurant format in mind. The amount you charge will include the cost of raw materials, cost of labor, costs of restaurant décor, regular maintenance costs and other such expenses. Ideally, the menu price must be the sum of your food cost, overhead cost, labor cost and projected profit for that item.

For this, you need to calculate your Gross Margin Value (GMV) which is the difference between the menu price and the food cost of a dish. The formula to calculate GMV is:

GMV= (Total Revenue- Cost of goods sold)/Revenue

Ideally, GMV should be around 60-65%. The GMV varies according to the type of restaurant that you're running. A fine-dine restaurant has higher overhead costs as compared to a casual dining restaurant. A Quick Service Restaurant (QSR) doesn't provide much customer service or infrastructure; hence, the GMV is set relatively lower than fine dining restaurants. The GMV of varied types of restaurants are as follows:

Fine dining: 75%

Casual dining: 55%

Quick service restaurant (QSR): 45%

You can not determine your dish price based on one strategy alone, but all your restaurant menu pricing strategies should target these numbers.

2. Charge More For Exotic Cuisine

The type of cuisine that you offer plays an essential role in deciding the restaurant menu pricing strategy. If your restaurant serves gourmet Italian food then, you can tag premium price rates on your food items despite the cost of raw ingredients. This is where you need to play with the psyche of the customers; the premium price tag will make them feel they are treating them with fine dining experience and rich gourmet foods. The delicacy of the dish might be lost if it is priced as economically as any other local cuisine or fast food items. Therefore, don't hesitate to charge a bit extra for an exotic dish and earn the higher rate of profits.

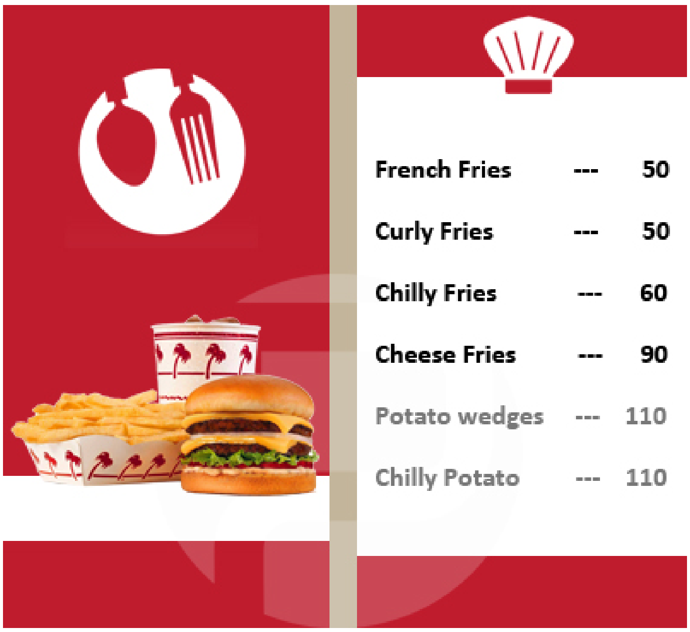
3. Revamp The Dishes With A Special Ingredient

The best way to optimize a restaurant menu is to play with different variations of the same dish. Add dishes that use low-priced basic ingredients except one or two exquisite ingredients to enhance the richness of the flavor and the aroma. You can sprinkle a few exotic herbs and spices to add fusion flavor twists to your existing dishes. Restaurant menu pricing strategies like this work with the intent of offering combination ingredients which lower the final making cost of the meal but still allows you to tap premium profit.

For example, you can add saffron leaves to plain *biryani* and charge more for providing a specialty dish, that is, *Zafraani biryani.*

4. Use Relative Pricing

Use relative restaurant menu pricing strategies to get your customers to buy more. When you place your high-profit items next to expensive dishes, your customers are likely to order the cheaper, yet the high-profit item. For example, a salted fries tagged at 50 rupees include nominal food costs but, still are sold at a high margin. On the other hand, chilly cheese fries are labelled at 90 rupees but, does not include the same margin. Thus, placing plain fries next to chilly-cheese fries will make the customer impulsively order regular fries, and you will earn more profit.



5. Decide The Right Price For The Right Quantity

There has always been a struggle in setting the price tag right. Many restaurants make the mistake of either charging too much or too less for food. While charging too much would drive the customers away, charging too little will diminish the margin of profits. Restaurateurs should also take into account the portion sizes while pricing the restaurant menu.

Here are some menu pricing blunders which you must avoid:

- Charging more for a large quantity – Charging more for larger quantity might not work well, especially new customers who are not aware of the exact quantity served.
- Charging less for less quantity – Many restaurants charge less for less quantity to stay ahead of the competition and encourage customers to order more but, the less quantity would be a put-off.
- Charging more for less quantity – A lot of restaurants tend to charge more for less quantity. This pricing strategy can dishearten customers since they are getting less food compared to what they paid – eventually, they might not return to your eatery.

Here is one tip to strike a right balance between the price and the quantity and avoid above three restaurant menu pricing blunders: do not decide the price solely based on the quantity. Serve a decent quantity of food and mention the number of servings alongside the price of each item to clear the confusion. At the same time, also take account of other crucial factors involved in processing and serving food.

6. Have A Chef Special In Each Section

In each section of the menu, you can have a 'Chef's Special' item. Customers are always looking (and often ask too) for something exclusive when they're ordering. A special item, especially the chef's favorite infallibly catches their fancy. Here are three quick steps to do it:

- Add a few exquisite ingredients to revamp the highest profit dish
- Name it as the 'Chef's Special.'
- Place it at the top or within a highlighted box in each category

In this manner, you can promote such items in each category, in your restaurant menu, charge a premium price for it and make profits on the same item than earlier.

7. Avoid Putting Currency Sign Next To Item Price

Keyword

Pricing strategy takes into account segments, ability to pay, market conditions, competitor actions, trade margins and input costs, amongst others.

The most basic yet the most ignored restaurant menu **pricing strategy** is not putting the Rupee sign next to the price. Placing a Rupee sign next to the price makes customers conscious about how much they are spending when they see X 'rupees' on that item. This might daunt and discourage customers a bit. The currency sign marks their expenditure on the budget conscious customer's mind – and this is what we need to minimize to coax them in ordering food without hesitating about the price. That's why we recommend removing the currency sign unless you are expecting guests using foreign currencies.

8. Write The Price At The End Of The Menu Description

Food descriptions of the dish are a must for all menu items. Write appetizing descriptions stating ingredients used in the dish to explain the delicacy of the item and build an appetite for the dish. The price stated at the end of the description might get customers craving for the item by the time they finished reading it. Customers with a craving for a particular item are likely to consider lesser about the price and more about the experience which they'd anticipate while reading the description.

9. Use Complimentary Item Pricing

You can offer discounts on complimentary items to increase the sale of related food items. For example, a customer ordering burger worth 50/70 rupees may not want fries worth of 50/60/90 rupees and a beverage. However, offering three items together as a combo pack worth rupees 130 might be a cost-effective deal for customers, and they want to order three items as a complete meal. A small discount on complimentary items will increase sales.

6.3 OBJECTIVE MENU PRICING METHODS

Methods emphasizing mark-up pricing, contribution margin pricing, ratio pricing, and simple prime cost pricing are objective approaches, as is the "bottomup" approach just discussed; that is, they address profit concerns and help to assure that guests receive value for the dollars they spend in the restaurant.

6.3.1 Mark-Up Pricing

A mark-up factor can be planned to cover all costs and to yield desired profit. For example, the ingredients mark-up method considers all product costs. The three steps are as follows:

Step 1: Determine the cost of the ingredients in the menu item being priced.

Step 2: Determine the multiplier to be used in marking up the ingredients' costs.

Step 3: Establish a base selling price by multiplying the ingredients' costs by the multiplier.

REMEMBER

A base selling price is not necessarily the final selling price. Rather, it is a starting point from which other factors must be assessed. These include the modifying factors discussed earlier, such as value (price relative to quality from the guest's perspective), supply and demand, production volume concerns, and prices charged by competitors.

Step 1: Determine the ingredients' costs. Assume that a chicken dinner has a cost of \$3.32. This cost represents the total food costs of all items comprising the dinner (chicken entrée, potato, vegetable, etc.) when prepared according to applicable standard recipes after pre-costing with current ingredient costs.

Step 2: Determine the multiplier. The multiplier (also called "mark-up") used to mark up the ingredient costs can be based upon the food cost percentage from an effectively developed operating budget. (Menu items priced, on average, to yield the budgeted food cost percentage create a foundation to generate revenue sufficient to cover food, other costs, and profit requirements.) For example, assume:

- Budgeted revenues \$875,000
- Budgeted food cost \$325,000
- Budgeted food cost % (food cost food revenues) 37.1%

$$\text{Multiplier} = \frac{1}{\text{Budgeted food cost percentage}} = \frac{1}{0.371} = 2.7 \text{ (rounded)}$$

Step 3: Multiply ingredient costs by multiplier.

Ingredient costs	×	Multiplier	=	Base selling price
\$3.32	×	2.7	=	\$8.96

If this base selling price appears reasonable, the chicken dinner would be sold for about \$9.00.

6.3.2 Contribution Margin Pricing

The contribution margin is found by subtracting a menu item's food cost from its selling price. It is the amount the item "contributes" to nonfood costs and profit.

Note: Earlier we defined the term "contribution margin" to be: Revenue Variable cost. This definition is a typical accounting related explanation of the term. In the context of food cost control, however, "contribution margin" has a slightly different meaning: Revenue Food costs. Food costs are one type of variable cost, so in the context of food cost control our definition is more specific.

The two steps used in contribution margin pricing are:

Step 1: Determine the average contribution margin per guest.

Step 2: Determine the base selling price for the menu item.

Assume that the approved operating budget for the restaurant indicates that all nonfood costs will be $395,000, that required profit is $50,000, and that 85,000 guests are expected to be served during the budget period.

Step 1: Determine the average contribution margin per guest. This is done by dividing all nonfood costs plus profit by the number of expected guests.

$$\frac{\text{Nonfood costs} + \text{Profit}}{\text{Number of expected guests}} = \text{Average contribution margin per guest}$$

$$\frac{\$395{,}000 + \$50{,}000}{85{,}000} = \$5.24$$

Step 2: Determine the base selling price for the menu item. This is done by adding the average contribution margin per guest (Step 1) to the item's ingredient cost. The base selling price for a menu item with a $3.60 ingredient cost would be $8.84 ($3.60 + $5.24 = $8.84).

This method is easy to use when reasonably accurate information is available from the operating budget. It is practical when costs associated with serving each guest are basically the same with the exception of varying food costs. This method tends to reduce the range of selling prices on the menu, since the only difference is reflected in the actual food cost incorporated into the selling price.

Wise restaurant managers know that, regardless of the amount spent by a guest, that guest should receive the same quality of service, environmental ambiance, cleanliness, and "dining experience." The only variable, then, is the menu item that is ordered with its associated food (ingredient) cost. Therefore, the contribution margin pricing method recognizes that each guest should pay his/her "fair share" of nonproduct costs and contributions to the restaurant's profits.

6.3.3 Ratio Pricing

The ratio pricing method assesses the relationship between ingredient costs and all non ingredient costs (all other controllable costs except food and all fixed costs) plus profit requirements and then uses this ratio to develop base selling prices for menu items. The steps to ratio pricing are:

Step 1: Calculate the ratio of ingredient costs to nonfood costs and profit.

Step 2: Calculate the total noningredient costs and profit for the menu item.

Step 3: Determine the base selling price.

Assume that the operating budget of a family-style restaurant (no alcoholic beverages are sold) indicates:

Total ingredient (food) costs	—	\$235,000
Total noningredient costs	—	\$560,000
Budgeted profit	—	\$80,000

Note: “Noningredient” costs include all expenses incurred by the restaurant other than food.

Step 1: Calculate the ratio of ingredient costs to noningredient costs plus profit. The following formula is used:

$$\frac{\text{Noningredient costs} + \text{Profit}}{\text{Ingredient costs}} = \text{Ratio}$$

$$\frac{\$560{,}000 + \$80{,}000}{\$235{,}000} = 2.72 \text{ (rounded)}$$

This ratio means that for each \$1 of revenue required to cover food costs, an additional \$2.72 in revenue is needed for noningredient costs and to meet profit requirements.

Step 2: Calculate the total noningredient costs and profit for the menu item. This is done by multiplying the ingredient costs of the menu item by the ratio (from Step 1). For example, if the ingredient cost is \$3.75, the amount of noningredient costs and profit required is \$10.20 [\$3.75 × 2.72 = \$10.20 (rounded)].

Step 3: Determine the base selling price for the menu item. This is done by adding the required noningredient cost and profit (from Step 2) to the ingredient cost of the menu item. The base selling price for the item above with a \$3.75 ingredient cost is approximately \$13.95 [\$3.75 + \$10.20 = \$13.95].

The ratio method of menu pricing is simple and can be based upon information in the operating budget. However, a restaurant offering food and beverages must separate nonfood costs and profit requirements in the two revenue centers.

6.3.4 Simple Prime Cost Pricing

“Prime cost” refers to the largest costs incurred by most restaurants: food and labor. Prime cost pricing involves assessing food and labor costs for the restaurant and factoring these costs into the pricing equation. The steps follow:

Step 1: Determine the labor costs per guest.

Step 2: Determine the prime costs per guest.

Step 3: Determine the base selling price.

Assume the manager knows the following from the operating budget:

Labor costs	—	$210,000
Number of expected guests	—	75,000
Desired prime cost percentage (food cost % + labor cost %)	—	62%

Step 1: Determine the labor costs per guest. Divide labor costs by the number of expected guests:

$$\text{Labor cost per guest} = \frac{\text{Labor costs}}{\text{Number of expected guests}}$$

$$\$2.80 = \frac{\$210{,}000}{75{,}000}$$

Step 2: Determine the prime cost per guest. The labor cost per guest ($2.80) is added to the menu item's ingredient cost. Assume an ingredient cost of $3.75:

$$\underset{\text{(ingredient cost)}}{\$3.75} + \underset{\text{(labor cost per guest)}}{\$2.80} = \underset{\text{(prime cost per guest)}}{\$6.55}$$

Step 3: Determine the menu item's base selling price. This is calculated by dividing the prime cost per guest (Step 2) by the desired prime cost percentage:

$$\text{Base selling price} = \frac{\text{Prime cost per guest}}{\text{Desired prime cost \%}}$$

$$\$10.56 = \frac{\$6.55}{0.62}$$

The objective pricing methods discussed above are relatively easy to use because they incorporate information from the approved operating budget ("profit plan") of the restaurant. Perhaps the single most challenging calculation in all the above methods is that involving ingredient costs. The manager must have a standard recipe pre-costed with current financial information to use any pricing method based at least in part on product cost. However, the need for standard recipes permeates all aspects of operating control, and pre-costing has become much easier with the advent of applicable software.

6.3.5 More About Multipliers And Pricing Tactics

Multipliers were briefly noted above in our review of mark-up pricing. We noted that a rational way to determine the multiplier was to use information from the operating budget (budgeted food costs divided by budgeted revenue). This approach is relatively simple for a restaurant having only one revenue center. (For example, a "family-style" restaurant that serves no alcoholic beverages.) It is obvious that 100% of all profit must be obtained from the food products sold. Likewise, all costs must be recovered from the applicable revenue.

Keyword

Product cost refers to the costs incurred to create a product. These costs include direct labor, direct materials, consumable production supplies, and factory overhead.

Food-Only Restaurants

It is often easier to control **product costs** (food or beverage) than other costs. Since pricing mark-ups are generally based upon product costs it seems reasonable to estimate the amount that can be spent for product purchases. To determine the maximum (allowable) amount that can be spent to purchase products if the restaurant serves only food the following approach can be used:

$$\begin{matrix}\text{Total forecasted}\\ \text{revenue}\end{matrix} - \left[\begin{matrix}\text{Total nonproduct}\\ \text{costs}\end{matrix} + \begin{matrix}\text{Required}\\ \text{profit}\end{matrix}\right] = \begin{matrix}\text{Allowable product}\\ \text{(food) costs}\end{matrix}$$

If total forecasted food revenues approximate those in the calculations, if nonproduct costs do not exceed budget estimates, and if allowable product costs are not exceeded, revenue should be available to meet both nonproduct costs and the restaurant's profit requirements. The same process can be used in a beverage-only (bar) operation to determine the amount that can be spent on beverage products.

The following example reviews the three-step process to price for profit that can be used by a restaurant selling only food. Assume the following from the restaurant's annual operating budget:

- Total annual food revenues will be $750,000.
- All expenses other than food ("nonfood" costs) will be

$375,000. (These include all overhead and variable costs except cost of goods sold: food.)

- Profit required is $65,000 (before tax).
- The food cost of a menu item when prepared according to a pre-costed standard recipe is $4.40.

Step 1: Calculate allowable food cost.

$$\begin{array}{ccccc} \text{Total forecasted revenue} & - & [\text{All nonfood costs} + \text{Profit}] & = & \text{Allowable food cost} \\ \$750{,}000 & - & [\$375{,}000 + \$65{,}000] & = & \$310{,}000 \end{array}$$

The above example indicates that if estimated revenue will be $750,000, and if nonfood costs and profit needs will be $440,000 ($375,000 + $65,000), the manager cannot spend more than $310,000 to purchase food.

Step 2: Calculate multiplier.

$$\frac{\text{Budgeted food sales}}{\text{Allowable food costs}} = \text{Multiplier}$$

$$\frac{\$750{,}000}{\$310{,}000} = 2.42$$

Note: The multiplier can also be calculated as follows:

$$\frac{1}{\text{Budgeted food cost} \div \text{Budgeted revenue}} = \frac{1}{0.413} = 2.42$$

Step 3: Calculate base selling price of menu item.

$$\begin{array}{ccccc} \text{Multiplier} & \times & \text{Standard recipe cost} & = & \text{Base selling price} \\ 2.42 & \times & \$4.40 & = & \$10.65 \text{ (rounded)} \end{array}$$

The base selling price of the menu item ($10.65) must be adjusted as the actual selling price is determined. Factors that affect the determination of the actual selling price include:

- perceived guest value
- competition
- “price rounding”
- traditional prices charged

This approach to pricing allows the manager to carry profit needs from the operating budget on into the calculations to set selling prices.

6.3.6 Food and Beverage Restaurants

If the restaurant sells food and beverage products (as is often the case), the required profit can be generated from the sale of either (and/or both) products. More planning becomes necessary in the pricing decision because both profit and costs must be allocated between the two departments.

Allocating Required Profit

How can profit requirements be allocated between departments? If 75% of total revenue is generated by the food operation, it may be unlikely to expect that 75% of the required profit should be generated by this department; there is generally a higher percentage of profit per dollar of sales from the beverage operation. To require the food department to generate a higher level of profit than necessary is probably unreasonable: The selling price of food items would need to be unreasonably high. Then there would be less value in the dining experience from the guests' perspective and revenue/profits would be likely to decrease. What is an alternative?

One approach is to require the foodservice department to pay for food costs that it directly incurs and to then allocate nonfood and nonbeverage costs between the departments. With this plan the amount of profit, if any, generated by food sales is first assessed. The beverage operation is then managed to recover the remaining required profit.

Allocating Costs

Food and beverage costs should be charged to the food and beverage departments, respectively. Nonproduct costs must then be allocated between both departments. A simple but, unfortunately, not very accurate proration method would consider the percentage of total sales (if 75% of all revenues are from food sales, then 75% of all costs other than food and beverage will be applicable to foodservice; 25% of nonproduct costs will be applicable to the beverage operation).

It is also possible (and more accurate) to prorate nonproduct costs on some basis other than revenues. Unfortunately, more accurate allocation methods that involve separate allocations for each cost are more time consuming, and for this reason are of less interest to many managers. However, a compromise that involves careful allocation of large expenses by a rational means and the combined allocation of small expenses on the basis of simple revenue percentages may be useful.

Establishing Selling Prices

The following example reviews a five-step process that can be used to determine a base selling price for food and beverage items. To simplify, all nonproduct costs will be allocated on the basis of revenue percentage.

Let's assume:

- The restaurant must generate $60,000 before-tax profit.
- The annual operating budget estimates that:
  - —Total food revenue will be $600,000.
  - —Total beverage revenue will be $125,000.
  - —Food costs will be $216,000.
  - —Total nonproduct costs will be $399,000. (This includes overhead and all variable costs except direct food costs and beverage costs.)
- The standard recipe indicates that the food cost for one portion of a menu item is $4.85.
- The beverage cost of a drink, prepared according to a standard recipe, is $1.10.

Step 1: Calculate profit from sale of food.

$$\begin{matrix}\text{Food} \\ \text{revenue}\end{matrix} - \left[\text{Food costs} + \begin{matrix}\text{Prorated share of nonfood} \\ \text{beverage costs}\end{matrix}\right] = \text{Profit from sale of food}$$

$$\$600{,}000 - [216{,}000 + 83\%\text{[14]}\ (399{,}000)] = \text{Profit from sale of food}$$

$$\$600{,}000 - [216{,}000 + 331{,}170] = \$52{,}830$$

These calculations tell the manager that, with the cost allocation process used, $52,830 of the required $60,000 before-tax profit will be generated from sale of food. The remainder of required profit must be generated by beverage sales.

You have learned that information developed to this point can help establish a base selling price for a menu item. Since the operating budget estimates that food revenues will approximate $600,000 and food costs will be $216,000, a mark-up is established:

$$\text{Mark-up} = \frac{\text{Budgeted food revenue}}{\text{Budgeted food costs}} = \frac{\$600{,}000}{\$216{,}000} = 2.78\ (\text{rounded})$$

The base selling price of our menu item can now be calculated:

$$\begin{array}{ccccc} \text{Base selling price} & = & \text{Price multiplier} & \times & \text{Standard food cost} \\ \$13.48 & = & 2.78 & \times & \$4.85 \end{array}$$

These procedures are identical to those illustrated in the pricing model suggested above for a restaurant selling only food (no alcoholic beverages).

Step 2: Calculate profit from sale of beverage.

$$\begin{array}{ccccc} \text{Total required profit} & - & \text{Profit from food sales} & = & \text{Profit from beverage sales} \\ \$60{,}000 & - & \$52{,}830 & = & \$7{,}170 \end{array}$$

Step 3: Determine allowable beverage cost.

$$\begin{array}{c}\text{Total beverage}\\\text{revenue}\end{array} - \left[\begin{array}{c}\text{Prorated share of}\\\text{nonfood/beverage}\\\text{expenses}\end{array} + \begin{array}{c}\text{Profit from}\\\text{beverage sales}\end{array}\right] = \begin{array}{c}\text{Allowable beverage}\\\text{cost}\end{array}$$

$$\$125{,}000 - 17\%^{15}\,(399{,}000) + \$7{,}170 = \text{Allowable beverage cost}$$

$$\$125{,}000 - \quad [67{,}830 + 7{,}170] \quad = \quad \$50{,}000$$

Step 4: Calculate the mark-up.

$$\text{Mark-up} = \frac{\text{Budgeted beverage income}}{\text{Allowable beverage cost} - \$50{,}000} = \frac{\$125{,}000}{\$50{,}000} = 2.5$$

Step 5: Calculate base selling price of drink.

$$\begin{array}{ccccc} \text{Mark-up} & \times & \text{Standard recipe cost} & = & \text{Base drink selling price} \\ 2.5 & \times & \$1.10 & = & \$2.75 \end{array}$$

The price of the drink ($2.75) would now be adjusted to fit the needs of the restaurant; for example, if base drink selling prices for other popular house drinks average about $2.50, and if they were of approximately equal popularity, an actual selling price ranging from $2.60 to $2.70 might be established for all drinks in this drink category. (The drink price might be rounded to the highest $0.05 to make it easier for service personnel to remember prices and to make change.)

Adjusting the Allowable Beverage Cost

The preceding plan assumes that the food department will make a significant contribution to the required profit. If it is operating efficiently, and if menu pricing is done correctly, this should be the case. Managers must constantly ensure that required control procedures are utilized. The pricing plan also assumes that profit requirements will not be met by the sale of food alone; rather, the beverage department will make an additional contribution. This necessary contribution is better ensured by adjusting the allowable beverage cost. (In other words, if more profit is required, beverage costs must be lower; if less profit is needed, allowable beverage costs can be higher.)

A problem occurs when allowable beverage costs (which cannot be exceeded if necessary profit levels are to be attained) are not high enough to provide desired standards of beverage service. There are several ways to resolve this problem. For example, the manager can examine the food operation to see if costs can be reduced and/or revenues can be increased. This practice should always be followed, but becomes critical when anticipated revenue will not be sufficient to cover both expected expenses and required profit. An increase in profits from the food operation will increase the amount that can be spent on beverages. (Since increased food profits decrease beverage profit requirements, revenue is released for beverage purchases that would otherwise need to be reserved for profits.)

Likewise, managers can examine nonproduct costs incurred by the beverage operation; if these can be reduced it will free additional dollars to spend on beverage purchases. It is also possible to consider increasing the selling prices of food and/or beverages; if this is done (and if gross revenues do not decrease because of guests' resistance) additional revenue will be generated that can be used to increase beverage purchases. Note: Extreme caution is necessary if this alternative is considered. Restaurants often see raising selling prices as an "easy" option; nothing must be done (except print new menus!); it is more difficult and time consuming to carefully analyze the existing operation and to first reduce costs to provide additional funds for beverage purchases. But as prices are increased, the guests' perception of reduced value may result in a loss of customers and decreased revenue. It is difficult to judge when guests will react negatively to price increases. Therefore, it is generally better to look within the operation for ways to decrease costs before increasing selling prices.

Another alternative for increasing allowable beverage costs is to increase revenues (food or beverage) by expanding to a larger market and/or by developing additional repeat business. Creative advertising, in-house guest interestbuilding activities, and other internal/external marketing/promotional techniques may increase revenues. As revenues increase, a smaller percentage of revenues is needed to meet cost obligations; profit increases, and again, additional funds are available to purchase beverages. It is also possible to "live with" the allowable beverage cost. Some managers opt to purchase lower quality products, offer smaller portions, etc., to stay within allowable beverage restraints. These tactics may be met with guest resistance; knowledge of what the market will and will not tolerate becomes important.

A final alternative is to consider accepting a reduced profit return. While this alternative is obviously unattractive, it is frequently a better choice than raising prices. Likewise, if ways to increase revenue and/or reduce costs are not found, and if required quality standards cannot be met with reduced allowable beverage costs, few other alternatives remain. Many restaurants must accept a low (or no) profit return during their early years of operation. This alternative may be reasonable in the short term, then, but becomes less feasible as the restaurant matures. An effective cost identification and control system is the best assurance that profit requirements will be consistently met by the restaurant.

6.3.7 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?	IF NOT DONE: TARGET COMPLETION DATE
1. Managers review menu prices on a pre-determined time schedule and allow for more frequent revision, if necessary.	❑	❑	❑		
2. The manager avoids use of subjective pricing strategies when assigning menu prices.	❑	❑	❑		
3. Managers routinely review competitors' pricing structures for comparison purposes.	❑	❑	❑		
4. The impact, if any, of elasticity of demand is considered prior to any changes in menu item prices.	❑	❑	❑		
5. The restaurant's profit requirements are first considered when establishing menu prices.	❑	❑	❑		
6. The manager uses objective pricing strategies when determining menu selling prices.	❑	❑	❑		

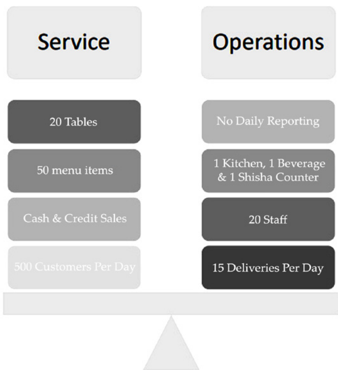
7. Managers regularly compute product ingredient costs for each menu item.	❑	❑	❑		
8. Data from the operating budget is used to determine allowable product (food) costs when developing menu selling prices.	❑	❑	❑		
9. When operated as two separate departments, food and beverage costs are allocated to each of these units when selling prices are determined.	❑	❑	❑		
10. Managers investigate all possible areas of operating expense reduction prior to increasing menu prices.	❑	❑	❑		

CASE STUDY

RESTAURANT: IMPROVING SERVICE & PERFORMANCE

Background

For a local restaurant business owner, controlling their operations remotely had always proved to be a challenge. They had employed a manager to run daily operations, but accurate and timely reporting was a challenge with the owner receiving excel reports for limited information. In addition they did not employee a trained finance person to manage their accounts or VAT To improve his operations profitability, service, cash controls and reporting, he contacted Simply Solved to propose a solution.



The Problem

The owner had several objectives and wanted to improve the business's profitability, improve service and reduce the number of people handling cash as well as improve the quality of his reporting. He did not believe increasing headcount was sustainable, it helped address some issues but reduced the business profitability greatly with additional revenue benefits. Following a review and site visit, we identified some key issues:

- Limited controls on food pricing & discounts
- Customer orders sent to kitchen by written paper or radio took time and could be inaccurate missing details
- Point of Sale system was just used for payment collection
- It also did not comply to UAE accounting & Tax and had poor reporting features
- Cash was handled by several people and uncontrolled

The Solution

We addressed all his key issues with required changes to processes and implementing IT solution with workflow management that could control:

Sales

Customer experience from entering the restaurant, table management, order taking, dispatch to kitchen, service delivery to payment.

Operations

Ordering supplies, inventory management, accounting and VAT

Reporting

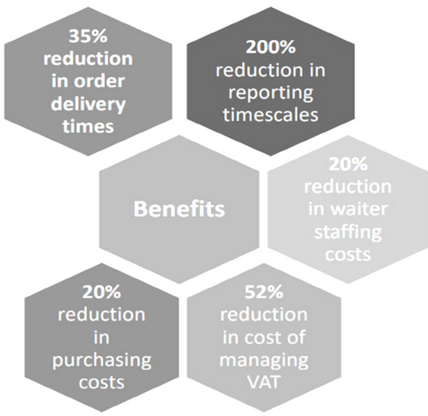
Detailed real time reporting to report on revenue, cost, stock scheduling, service delivery, waiter performance etc.

Accounting & VAT

Cost effective outsourced accounting & VAT

The Result

By focusing on workflow automation and setting up controls into simple process supported by a complete solution, we able to significantly improve the customer experience, reduce costs and provide the rich real-time reporting to operate the restaurant. Our solution and model is modular and transferrable to any restaurant format to help you manage business more effectively, making it an asset running your business. Our solution is UAE FTA compliant, fully configurable and can be implemented in days.



SUMMARY

- A manager using this method subjectively establishes selling prices based upon a personal belief about price levels that represent value for the guests. This emphasis is often ineffective; many managers do not know about their guests' real concerns; clearly, this approach does not relate to the profit requirements of the restaurant.
- The "highest price" method. Also based on the manager's perceived ability to "outguess the guest," this method suggests that selling prices be set as high as possible and then reduced slightly to allow for a margin of error in management's judgment about the guests' ability to pay.
- Accounting systems used by some restaurants do not identify all costs, and even if they do, they may not use an allocation process to spread overhead (indirect) costs between food and beverage departments.
- The pricing method used for the beverage department is often even more simplified. The manager "matches up" a drink item with one of the existing beverages categories offered to determine a selling price.
- The guest paying a higher price may not relate the price directly to the product being purchased. He/she may be less price-conscious than the guest in the low–selling price restaurant; the purchase decision may involve intangible (nonproduct) elements, the value of which is more difficult to quantify.
- Elasticity is a term relating to the effects of selling-price increases or decreases on total revenues. Elastic demand describes a situation in which a reduction in selling price yields sales of enough additional units (meals or beverages) to increase total revenues, or a situation in which an increase in price yields lower sales, and therefore a decrease in total revenues.
- Profit must be planned; costs must be identified and controlled. These standards should be incorporated into the pricing system used by the restaurant. These ideas can be combined into a single focal point if the manager merely regards profit as a "cost of doing business."

MULTIPLE CHOICE QUESTIONS

1. **(Selling price - cost price) is called**
   a. loss
   b. marked price
   c. discount
   d. profit
2. **The manager must have a standard recipe pre-costed with current financial information to use any pricing method based at least in part on product cost.**
   a. True
   b. False
3. **(Cost price - selling) price is equal to**
   a. discount
   b. marked price
   c. profit
   d. loss
4. **Restaurant charges less to the customers who come early. It is a type of**
   a. Customer segment pricing
   b. Time pricing
   c. Product form pricing
   d. Channel pricing
5. **Managers can examine nonproduct costs incurred by the beverage operation; if these can be reduced it will free additional dollars to spend on beverage purchases.**
   a True
   b. False

Review Questions

1. What is the average restaurant profit margin?
2. Discuss about the menu pricing methods.
3. How to calculate ratio pricing?
4. How to increase your restaurant's profits?
5. What is prime cost pricing?

Answer to Multiple Choice Questions

1. (d) 2. (a) 3. (d) 4. (b) 5. (a)

REFERENCES

1. BLS, "Occupational Outlook Handbook: Food and Beverage Serving and Related Workers" (January 8, 2014) online
2. Dixon, Huw (2001). "The Role of imperfect competition in new Keynesian economics" (PDF). Surfing Economics: Essays for the Inquiring Economist. New York: Palgrave.
3. Etymology of Cabaret. Ortolong: site of the Centre National des Resources Textuelles et Lexicales (in French). Retrieved January 12, 2019.
4. *Goodale, Gloria (October 19, 2007). "At fast-food joints, try the secret menu". Boston: Christian Science Monitor*
5. Jayaraman, Saru (Summer 2014). "Feeding America: Immigrants in the Restaurant Industry and Throughout the Food System Take Action for Change". Social Research. 81 (2).
6. Kerry Miller, "The Restaurant Failure Myth", *Business Week*, April 16, 2007. Cites an article by H.G. Parsa in *Cornell Hotel & Restaurant Administration Quarterly*, published August 2005.
7. Michael Woodford (2003), *Interest and Prices: Foundations of a Theory of Monetary Policy*. Princeton University Press.
8. Paradowski, Michał B. (2017). "What's cooking in English culinary texts? Insights from genre corpora for cookbook and menu writers and translators". The Translator. 24: 50–69.

CHAPTER

7

ACCOUNTING ASPECTS OF FOOD AND BEVERAGE CONTROL

"The moment you make a mistake in pricing, youre eating into your reputation or your profits."

- Katharine Paine

INTRODUCTION

The effective manager has to manage and control all the various operating expenses in a foodservice operation. In the end, the goal is typically to make a profit. Food and beverage expenses combined are one of the largest expense categories for foodservice operations. One of the key figures needed each month (or even more often) is the cost of goods sold. The food & beverage cost of goods sold is the dollar amount spent on items actually used

LEARNING OBJECTIVES

After studying this chapter, you will be able to:

1. Basics Food and Beverage Services
2. Purchasing, Receiving, Storage, and Inventory of Beverages
3. Beverage Controls and Service Procedures

to provide the menu items sold to the guests. The amount may significantly differ from the total spent on food purchase since:

- Items purchased in bulk are not entirely used during the accounting period (refer to the section on inventory)
- Items are consumed but not always sold to guests (employee meals, complimentary meals served for promotion purposes, etc.)

The food & beverage cost of goods sold (usually referred to as Food & Beverage Cost in the industry) is expressed as both a dollar amount and a percentage of food & beverage revenues.

From an accounting and financial standpoint, a restaurant inventory is the dollar value of the food and beverage items that are held in storage. While in storage, the inventoried items are not considered a cost until used or sold. Just like cash, food and beverage inventory is a company asset. Unlike cash, however, inventory values may decrease since food and beverage items are perishable and subject to spoilage and theft.

Holding inventory has the potential to incur significant expenditures including operating expenses (such as spoilage, obsolescence, theft, and facility expenses) and capital investments (such as the construction of the premises and refrigeration equipment.) Additionally, operations immobilizing too much cash in inventory could eventually need to borrow money to pay for other expenses.

Accordingly, managers need to implement stringent inventory management systems to protect the value of their inventory with procedures that avoid over-ordering (cash spending) and spoilage, including security measures for accessing the premises, proper requisition procedures for removing inventoried products, and adequate rotation of perishable items.

7.1 BASICS FOOD AND BEVERAGE SERVICES

Food and beverage services sector contributes a great deal to the profits in hospitality industry. With the increase in importance of business meetings, a range of personal and social events, a large number of customers visit catering establishments frequently. The food and beverage professionals tirelessly work to intensify customers' experience through their service.

The F&B Services providing businesses deliver food and beverages to their customers at a particular location (on-premise) such as hotel, restaurant, or at the customer's intended premises (off-premise). Food and Beverage Services can be broadly defined as the process of preparing, presenting and serving of food and beverages to the customers.

F&B Services can be of the following two types:

On Premise: Food is delivered where it is prepared. The customer visits the premise to avail the food service. The premises are kept well-equipped and well-finished to attract customers to avail F&B service.

For example, restaurants, pubs, etc.

Off Premise or Outdoor Catering: This kind of service includes partial cooking, preparation, and service at customer's premises. It is provided away from the F&B Services provider's base on the occasion of major events which call for a large number of customers.

There are two broad types of F&B Service's operations:

Commercial: In this case, F&B Services is the primary business. The most known commercial catering establishments are hotels, all kinds of restaurants, lounges, cafeterias, pubs, clubs, and bars.

Non-Commercial: Non-commercial operations are secondary businesses in alliance with the main business. These F&B services mainly cater to their consumers with limited choice of food and beverages. These establishments often run under contracts. For example, food and beverage services provided at hospitals, hostels, and prisons.

7.1.1 Types of Food and Beverage Services

There are a number of service styles to be followed when it comes to how food and beverage should be served to the customers. The following are the most prominent styles:

Table Service

In this type of service, the guests enter the dining area and take seats. The waiter offers them water and menu card. The guests then place their order to the waiter. The table is covered in this service. It is grouped into the following types.

English or Family Service

Here, the host contributes actively in the service. The waiter brings food on platters, shows to the host for approval, and then places the platters on the tables. The host either makes food portions and serves the guests or allows the waiter to serve. To replenish the guests' plates, the waiter takes the platters around to serve or to let the guests help themselves. This is a common family service in specialty restaurants where customers spend more time on premise.

Keyword

A **presentation** conveys information from a speaker to an audience. Presentations are typically demonstrations, introduction, lecture, or speech meant to inform, persuade,inspire, motivate, build goodwill, or present a new idea/product

American or Plate Service

The food is served on guest's plate in the kitchen itself in predetermined portion. The accompaniments served with the food, the color, and the **presentation** is determined in the kitchen. The food plates are then brought to the guest. This service is commonly used in a coffee shop where service is required to be fast.

French Service

It is very personalized and private service. The food is taken in platters and casseroles and kept on the table of guests near their plates. The guests then help themselves. It is expensive and elaborate service commonly used in fine dining restaurants. This service has two variants:

- Cart French Service: The food is prepared and assembled at tableside. The guests select food from the cart while sitting at their tables and are later served from the right. It is offered for small groups of VIPs.
- Banquet French Service: The food is prepared in the kitchen. The servers serve food on each individual's plate from guest's left side. For replenishment, the servers keep the food platters in front of the guests.

Gueridon Service

In this service, partially cooked food from the kitchen is taken to the Gueridon Trolly for cooking it completely. This partial cooking is done beside the guest table for achieving a particular appearance and aroma of food, and for exhibiting showmanship. It also offers a complete view of food. The waiter needs to perform the role of cook partially and needs to be dexterous.

Silver Service

In this service, the food is presented on silver platters and casseroles. The table is set with sterling silverware. The food is portioned into silver platters in the kitchen itself. The platters are placed on the sideboard with burners or hot plates. At the time of serving, the waiter picks the platter from hot plate and presents it to the host for approval and serves each guest using a service spoon and fork.

Russian Service

It is identical to the Cart French service barring the servers place the food on the platters and serve it from the left side.

Assisted Service

Here, the guests enter the dining area, collect their plates, and go to buffet counters and help themselves. The guests may partially get service at the table or replenish their own plates themselves.

Buffet Service

It this type of service, the guests get plates from the stack and goes to buffet counter where food is kept in large casseroles and platters with burners. The guests can serve themselves or can request the server behind the buffet table to serve. In sit-down buffet restaurants, the tables are arranged with crockery and cutlery where guests can sit and eat, and then replenish their plates.

Self Service

In this type of service, the guests enter the dining area and select food items. They pay for coupons of respective food items. They go to food counter and give the coupons to avail the chosen food. The guests are required to take their own plates to the table and eat.

Cafeteria Service

This service exists in industrial canteens, hostels, and cafeterias. The menu and the space is limited; the cutlery is handed over to the guests. The tables are not covered. Sometimes high chairs are provided to eat food at narrow tables. It is a quick service.

Single Point Service

In this type of service, the guest orders, pays for his order and gets served all at a single point. There may be may not be any dining area or seats. The following are the different methods of Single Point Service.

Kiosks

The customer enters the choice and amount of money physically and the machine dispenses what customer demanded accurately.

Take Away

Customer orders and avails food and beverage from a single counter and consumes it off the premises.

Vending

The customer can get food or beverage service by means of automatic machines. The vending machines are installed in industrial canteens, shopping centers, and airports.

Special Service

It is called special service because it provides food and beverage at the places which are not meant for food & beverage service. The following are the different methods of special service.

Grill Room Service

In this type of service, various vegetables and meats are displayed for better view and choice. The counter is decorated with great aesthetics, and the guest can select meat or vegetable of choice. The guest then takes a seat and is served cooked food with **accompaniments**.

Keyword

Accompaniment is the musical part which provides the rhythmic and/or harmonic support for the melody or main themes of a song or instrumental piece.

Tray Service

Method of service of whole or part of meal on tray to customer in situ, such as hospitals, aircraft, or railway catering.

Trolley/Gueridon Service

Food is cooked, finished or presented to the guest at a table, from a moveable trolley. For example, food served on trollies for office workers or in aircrafts and trains.

Home Delivery

Food delivered to a customer's home or place of work. For example, home delivery of pizza or Meals on Wheels.

Lounge Service

Service of variety of foods and beverages in lounge area of a hotel or independent place.

Room Service

Here food is served to guests in their allotted rooms in hotels. Small orders are served in trays. Major meals are taken to the room on trolleys. The guest places his order with the room service order taker.

The waiter receives the order and transmits the same to the kitchen. Meanwhile, he prepares his tray or trolley. He then goes to the cashier to prepare and take the bill. He then takes the bill along with the food order for the guests' signature or payment. Usually clearance of soiled dishes from the room is done after half an hour or an hour. However, the guest can telephone Room Service for the clearance as and when he has finished with the meal.

7.1.2 Outlets of Food and Beverage Services

Today, numerous types of food and beverage service outlets have come up in the market. They offer a wide range of food and beverage services that the customers can avail. The extent of service depends upon the type of service outlet. They include drive-through service of fast food where the customers can purchase their favorite food without having to leave their cars and pick-up points where food is delivered in minutes.

There are also some elite class fine dining outlets which exhibit classy articles in the house and provide elaborate **food services**.

Here are some famous types of food and beverage outlets:

Outlet	Menu	Ambience	Service
Airport Lounges	Wide menu for breakfast, lunch, and dinner with hot and cold beverages, salads, main meals, and desserts.	Soft instrumental music, soft lights, formal ambience, all appealing for having meals at leisure and resting gracefully at the airport	Self or Assisted service provided 24X7, round the clock. The traveler selects food and beverage of choice, and takes to the table himself.
Bars	Wide menu of soft drinks, alcoholic beverages, and light snacks.	Informal, relaxed atmosphere, energetic music, colorful flashy lights.	Push-low seating, speedy service of cocktails, mocktails, and snacks.
Cafeterias	Short dining menu with less food options. Follows cyclic meal plan.	Attached to educational institutes or industrial organizations	Self or assisted, pre-plated, low priced service.
Coffee Shops	Short menu with hot and cold beverages, snacks, and light meals.	Informal ambience with light music and moderate lighting.	Quick and mid-priced service for high customer turnover.

Keyword

Food service is the industry related to making, transporting or selling prepared foods to restaurants, hospitals, schools and lodging establishments.

Discotheque/ Nightclubs	Menu with snacks and beverages.	Strobe lights, laser lights, dance floor, lively music, informal and energetic atmosphere.	Entry permission for couples or members on charge, assisted service.
Family/ Casual Dining Restaurants	Elaborate menu of single or multiple cuisines which may change according to the operating hours.	Modestly furnished, Casual atmosphere.	Assisted, mid-priced service.
Fast Food Outlets	Limited menu of hot and Cold beverages with easily prepared and fast meals cooked in advance and kept warm.	Catchy trendy colored furniture, lights, and music.	Speedy service, minimum table service. The food is prepared in the kitchen, placed in the trays, and passed to the person at the counter, who then delivers to the customer. The customer picks up the trays and consumes it on premise.
Food Courts	Multi cuisine menu.	Multi-cuisine food outlets are located around modestly kept central dining area.	Speedy service with minimum personal attention. The customers pick up food and beverages of their choice from multiple outlets around and sit in the central dining area to consume.
Grill Rooms	Grilled meat or sea food with alcoholic/ non-alcoholic beverages.	Attached to star hotels, gardens, or independent, may have open kitchen. Eye-catching counters.	According to hotel policies.
Poolside Barbeque	Roasted meats, crunchy vegetables, and seafood with wines and beer.	Located near swimming pools, Informal, relaxed atmosphere, energetic music.	Self/assisted service.
Pubs	Mostly alcoholic menu with snacks.	Informal and social ambience with less lighting and more chatting.	Push-low seating, self, or assisted service.

Specialty/Ethnic Restaurants	Specific menus such as Chinese, Italian, Indian, Thai, or Mexican.	Follows specific theme. Interior Decoration is in line with the theme.	Uniform of the service staff, linen, and service ware are according to the theme and from the country where the food originates.
Take-away Counters	Limited or elaborate menu of food and beverages.	Frontend counter for selling is attached to the pantry.	Pickup service where customer places order, waits till it is completed, and picks the food and beverages to consume them off-premise.
Themed Restaurant	Limited menu that is based on the theme.	Architecture, lighting, and music induce the feel of the theme. Mostly informal ambience.	American/Assisted service.
Vending Machines	Pre-packaged chips, portioned foods, canned beverages.	Located in high labor cost and limited space areas such as transport hubs.	Complete self-service.

General Layout of F&B Outlets

Appropriate architecture of F&B outlet makes it prepare, present, and serve in optimum way and increase productivity. These are few basic considerations for various sections of F&B outlets:

Kitchen

It is farthest from the customers.

Store

It has large fridges, cupboards with multiple shelves, and lockers. It is attached to the kitchen.

Pantry

It is being the area where food or beverage is prepared ready to serve, it is located between the dining area and the kitchen.

Restrooms

There are two different schools of thought for location of restrooms some experts consider that the restrooms must be near the entrance and some think that it should be isolated from entrance or dining area.

General Considerations for F&B Services Layout

While designing an F&B outlet, one needs to consider every factor that contributes to the smooth running of operations right from food preparation, cooking, dish presentation, serving, and all allied tasks.

While designing commercial F&B outlets, the following points are important:

- Target customer segment (Youth/Men/Women/All).
- Type of food (Light Food/Fast Food/Fine Dining).
- Manner of food production (Cooking/Grilling/Boiling/Baking/Steaming).
- Type of food distribution (On/Off Premise).
- Availability of carpet area.
- Number of staff required.

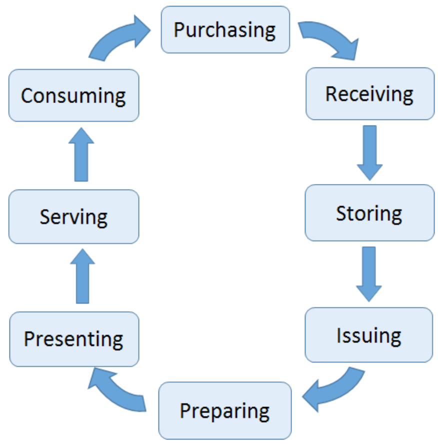
The kitchen is designed not to be directly visible. The chef cannot directly communicate to the guests. The guest tables and chairs are placed away from kitchen.

7.1.3 Operations of Food and Beverage Services

Food and Beverage Service operations involve a multitude of activities which engage the staff right from purchasing raw material, preparing food and beverage, keeping the inventory of material, maintaining service quality continuously, managing various catered events, and most importantly, analyzing the business outcomes to decide future policies.

Product Cycle in F&B Service

The purchasing department in F&B Services is responsible for purchasing, storing, and issuing the supply of raw food items, canned/bottled beverages, and equipment. The following is a typical product purchasing cycle:



The purchasing department works with accounts department to keep the information on allocated budget and balance budget.

The following factors influence purchasing:

- Size of F&B Organization
- Location of F&B Organization
- Availability and Size of Storage Space
- Organization Budget and Policies
- Availability of the commodity due to season

Purchasing Product

The purchaser is responsible for purchasing a product. He studies the market, and analyzes and selects suppliers, wholesalers, and the contemporary market prices. He then liaisons with suppliers and wholesalers to get good material at fair price and purchases the required commodities by following appropriate purchase procedures.

Receiving the Product

The receiver receives the products from the suppliers. He checks the product for right quality and quantity. He deals with the delivery personnel from the supplier's end and signs on the related receipts.

Storing and Issuing the Product

The store men carry out the task of storing received supply and issuing it to respective departments. They update the stock database, and manage old and new material in the stock. They also keep record of stock to the latest date.

Preparing and Presenting an F&B Product

This includes preparation of various food items and fresh beverages. The cooks prepare various foods and the bar tenders prepare cold beverages such as mocktails and cocktails. They also make the dish most presentable by arranging food on platter and decorating it in an attractive manner. The beverages are also decorated by using fruit slices, decorating the glasses, sippers, and stirrers.

Consuming the F&B Product

This part is played by the guests. At the service end, the respective staff takes inventory of the consumed and balanced stock of food and beverages and keeps it updated to latest figures.

Maintaining Food and Beverage Standards

It is very vital for an F&B Services organization or an F&B department in a large hotel to keep their standards of food and beverage high. If the quality of food and beverage along with the best service is what the guests liked, then the chances of the guests coming repeatedly and singing praises of what they received are high.

Food and Beverage Standards

Any food and beverage service business has a great responsibility of serving hygienic, safe, clean, and fresh food. The customers also rightfully question if the food or beverage they consume at the F&B Services outlet is healthy, safe, and fresh.

For ensuring food safety, a system named Hazard Analysis and Critical Control Points (HACCP) in Europe works to identify Critical Control Points (CCP) for the presence of physical, chemical, and bacterial hazards to food. HACCP has set guidelines and principles on producing healthy and safe food. It also enables food and beverage businesses to adhere to consistent safety and quality of food production.

In India, Food Safety and Standards Authority (FSSA) works towards setting standards for safe and hygienic food. In USA, Food Safety and Inspection Service (FSIS) is responsible for the safety of meat, poultry, and processed egg products. Also, the **Food and Drug Administration (FDA)** is responsible for virtually all other foods.

Managing Buffets, Banquets, and Catered Events

Before planning and executing buffets, banquets, or catered events, the respective managers and supervisors need to consider the following factors:

Keyword

Food and Drug Administration (FDA) is a federal agency of the United States Department of Health and Human Services, one of the United States federal executive departments.

Type of Event

It can be formal such as seminars, meetings, or conference, or informal such as a wedding reception, birthday party, employee outing, and alike.

Involvement of Various Persons

The participants such as decorating staff, planning staff such as managers, serving staff, supervising staff, whole sellers, and the guests.

Event Requirements

It is important to know the date and time of event, the number of expected guests, dance floor, audio or projector systems, or any special requirement demanded by the guests before planning the event.

Decors

It includes flowers, table arrangement, center-pieces, candles, artificial fountains/ waterfalls, decorative art pieces, plants and pots; for both formal and informal occasions with the involvement of décor artists. The display pieces may be carved, baked, or assembled; made of edible or non-edible substances according to the laid standards. The decoration needs to go in pair with the theme of the banquet, buffet, or some event.

Menu

According to the time of event, it can include starters, salads, breads, main courses (meats, poultry, or sea food), desserts (fruits, pastries, or frozen desserts), beverages, accompaniments, and garnishes according to the establishment standards. It must be hygienic, in-line with the occasion, and meeting the F&B Services establishment standards.

Serving Equipment

Depending upon the requirement of guests and serving style, it can include silverware, platters, table linens, and other required serving equipment. It also includes size and shape of tables and chairs.

Serving Norms

According to establishment norms, serving right food at right temperature, replenishing food platters timely, keeping the overall display neat and attractive, storing food and managing beverage consumption after service, cleaning buffet or banquet area, restoring plates, cutlery, Guerion trollies, and glassware after completion of service.

7.2 PURCHASING, RECEIVING, STORAGE, AND INVENTORY OF BEVERAGES

The alcoholic beverages are an investment in income-producing stock and there are many facets to making the best investment for the least money. Another part of the answer is that the purchasing and record-keeping processes are critical to other aspects of the business. Still another part is that alcohol has an irresistible attraction for many people so if you do not keep track of it, it will ‘‘evaporate,’’ so to speak. The goal of beverage purchasing is to provide a steady supply of ingredients for the drinks you sell at costs that will maximize profits. The purchasing function moves in a continuous cycle with several distinct phases:

Planning and ordering: Selecting what you need at the most advantageous prices.

Receiving: Taking delivery of exactly what you have ordered brands, sizes, and quantities at the specified prices and in good condition.

Storing: Keeping your beverage supplies in a place that is secure against theft and deterioration until needed.

Issuing: Transferring your beverages from storeroom to bar, where they will be used to make drinks for your customers.

REMEMBER

The sale of these drinks keeps the cycle revolving since you must continually replenish the supplies consumed. But the cycle does not revolve by itself; it must be managed. The process must be responsive to needs (sales volume and customer tastes), to the market (supply and price), to cash flow (money available for investment), and to indicators of change in any of these factors.

The beverage manager must know what is going on at all times. In a small operation purchasing may be the responsibility of the bar owner or the head bartender. Large operations usually have a full-time beverage manager, while hotel and restaurant chains often have an entire department devoted to purchasing and other aspects of beverage management. However the principles and problems are much the same, no matter how big or small the enterprise is.

7.2.1 Planning the Purchasing

The term purchasing, as it applies to food-and-beverage operations, is usually a two-step process. The first step is the selection process, which involves making the decisions about what is to be served; which brands, sizes, and quantities to buy; what to make from scratch or to purchase premade. Selection also impacts the amounts, styles, and sizes of glassware to be used. These must also be ordered in sufficient quantity and kept in **inventory**.

Keyword

Inventory is the raw materials, work-in-process products and finished goods that are considered to be the portion of a business's assets that are ready or will be ready for sale.

The second step is the procurement process, or the method used for purchasing items. This involves choosing and working with vendors, using a standard system of ordering, deciding on a budget and sticking to it, and determining how often to replenish stock.

Many factors go into making purchasing decisions. Some are management policies that once established should be followed to the letter. Others are day-to-day decisions based on current situations. They all boil down to what to buy, where to buy it, how much to buy, when to buy, and what to pay.

What to Buy

Deciding what to buy involves two basic policy decisions: the quality of the beverages you will pour and the variety of items you will have available. To meet customers' needs and avoid overstocked bars and storerooms, today's bar managers use a policy commonly known as category management.

This involves tracking what sells and what doesn't and using that information to create a beverage program that delivers the best product mix to customers and the maximum profit for the bar. Today's sophisticated point-of-sale (POS) system can be an invaluable tool in accomplishing this. The POS is very much like a personal computer. Its touch-screen technology and easy programmability give the user the ability to track multiple types of data, including the brands of alcohol used in a drink and the server who sold it.

In a large operation the POS terminals are workstations linked to a central computer, which is, ironically, also called a server.

Another feature of these systems is the capability to keep a running inventory, automatically ''deleting'' the standard amount of each liquor that is used to mix each cocktail. Theoretically this should give a bar manager almost instant usage numbers, which can later be compared with the actual physical inventory. Some systems can even be programmed to draft purchase orders and e-mail them to a wholesaler when inventory reaches certain levels.

In a large chain computerization and category management are tremendously helpful. A company that operates several units can compare brand movement among locations and refine the menus, inventories, and promotional strategies accordingly. For example Ruth's Chris Steak Houses, a popular Southern fine-dining chain based in Louisiana, noted that one bar sold hardly any cognac. This was because the cognac was located in a seldom-seen portion of the back bar.

Market Watch magazine is an additional source that can be used to track beverage trends and desirable brands. According to the research firm Impact Databank, a''hot'' brand is:

- An established brand with a minimum 20% annual growth rate.
- A brand that has experienced double-digit growth rates for the past three years.
- A product that is new but ''significant'' in some way. ''Hot brands'' must also meet annual volume requirements:
  - For spirits, 200,000 9-liter cases
  - For major domestic-beer brands, 3.4 million 2.25-gallon cases
  - For other, specialty-beer brands, 1.1 million 2.25-gallon cases
  - For imported beers, 1 million 2.25-gallon cases
  - For domestic wines, 250,000 cases
  - For imported wines, 200,000 cases

Quality and Variety

Quality should be a primary consideration in brand selection because it depends on your clientele: what they expect and what they are willing to pay for. It would be foolish to buy premium brands or boutique California wines for a low-budget clientele, and equally foolish not to offer such items in a luxury restaurant. As in everything else you must know your customers.

Beyond this you must consider the quality of your well brands, which are the liquors that you pour in mixed drinks when the customer does not ask for a specific brand. Also known as house brands or house liquors, these represent about half of the liquor used in an average bar. Choose a set of well brands and stick with them for the sake of consistency in your drink recipes. Many bars use inexpensive brands in the well on the theory that customers cannot tell the difference in a mixed drink. Other bars use familiar, advertised brands in the middle price range. Still others use premium brands—this is sometimes called a premium well or super well—that they feature with pride in their merchandising. By carrying premium brands in the well, in addition to making an impression, you eliminate having to carry well brands. This means less inventory and less cost. Premium brands are a good choice for bars where clientele is value-conscious, that is, willing to spend a little extra to receive a higher-quality drink. Super premium brands have the advantages of strong name recognition and customer loyalty, but they will not be worth the extra expenditure if you do not do a good job of letting your customers know that these brands are being used.

Gin, Bourbon, Vodka, Scotch, Rum, and Tequila

Light and dark liquors are interspersed so they are less likely to be used accidentally by a bartender in a hurry.

The second major decision is the variety of items you will stock. The average bar in the United States may carry as many as 130 liquors and liqueurs on the back bar, and a showy back bar lined with bottles is the hallmark of many operations. Some bars take pride in never having to tell a customer, ''I'm sorry but we do not have that.'' Such a policy, while it can be good merchandising for some types of clientele, has the potential of expanding inventory indefinitely with items that do not move. Liquor that does not sell does not earn a penny of profit, except to the degree that it contributes to atmosphere and image on that great-looking back bar.

Many bars prefer to limit their offerings to popular and well-advertised brands of each item, with the number of brands varying with the type and size of the operation. If a customer calls for a brand that you do not carry, you probably would not lose either the sale or the customer if you can offer a well-known brand of com-parable quality. But be sure to offer the alternate to the customer; do not try to substitute another brand without the customer's knowledge. That is a very bad practice that will only create an image of mistrust for your place and your bar-tenders. Still another approach is to deliberately limit the number of brands and items that you stock by developing a printed drink menu based on a small number of beverages.

Where you draw the line on the numbers of brands and items that you stockwill depend on your clientele, your type of enterprise, your volume of business, and the money available for such an investment. But it is wise to draw the line somewhere—then hold it. A common mistake is to let your inventory grow, overtime, to unmanageable levels. Products do fall out of fashion, as in any industry. One way to avoid a proliferation of brands and bottles is never to add a new item of unpredictable demand without eliminating a slow-moving item from your list. In this case ''slow-moving'' means a product that takes nine months or longer to use up a single bottle.

No matter how sophisticated the ordering process, buying individual products is still mostly a matter of brand selection and common sense. When the liquor or beer brand concerns the customer, buy the brands that your customers will buy. For your well select the brands that make the quality of drinks you want to pour. This applies to your vermouth and liqueur choices as well. It is a good idea to taste your own mixed drinks with different brands of spirits and liqueurs. Generic liqueurs in particular can taste quite different from one brand to another, and the expensive imported brands are not necessarily the best.

Purchasing Wines

Buying wines is somewhat more complicated than buying beers and spirits. One reason is that customer demand is less clear-cut. For house wines more and more enterprises are replacing generic wines with inexpensive varietal wines in 1-literand 1.5-liter bottles. Some restaurants pour house wines by the glass from 750-millileter bottles and have the same wines available for sale by the bottle. An alert waiter can often convert orders for two or three individual glasses to a bottle of wine for the table.

Wines for a printed wine list require a different approach. Because wines vary from one winemaker to another, one vintage to another, and one year of age to another, you must either rely on an expert or know a good deal about wines yourself. You can safely buy most young whites, rose´s, and some of the simpler reds and sell them right away. The older the vintage date, the more skeptical you should be.

For now remember that the distributor's sales force is knowledgeable about industry trends and will often bring news of wine bargains. You will need to decide which you should buy, and which should you pass up.

- *Post-offs and closeouts* are deals that help distributorships move slow-selling wines or to clear out a product line that they are soon planning to drop altogether. Look carefully at the offer and consider the background details. Why are these wines not selling? Are they too old? Not quite ''good enough?'' Were they over-priced to begin with and are just now being offered at a fair price for their quality?
- *Vintage clearances* are offered to make space in a distributor's warehouse for incoming newer wines. These offers usually come with a minimum number of cases that must be ordered to receive the discounted price, which means a sizable investment on your part.
- *Exclusives* are deals offered to a buyer because of a solid relationship witha supplier, whether it is the sales rep who calls on you regularly or someone higher up in the organization. The word exclusive should indicate exactly what it means: that your business is the only bar in the area pouring this particular wine. Whether you participate in an exclusive deal depends mostly on the wine savvy of your customer base. If your customers will not necessarily appreciate the exclusivity of the deal or if the products are not upscale enough to warrant exclusivity, it is acceptable for you to pass it up. An exclusive arrangement may also come with minimum orders and other special requests by the distributor.

REMEMBER

We suggest making the distributor an offer that you can afford. Yes, it is an investment of both cash and storage space, but you may be surprised at how much room for negotiation there is in this type of deal.

Supplier Relations

When you have a choice price is certainly one reason to buy from one supplierrather than another, and you should always get competitive bids for large orders from different suppliers. But there are many other considerations, including which services a supplier does or does not offer. For instance:

- How often does the supplier deliver? The more frequently, the better; and daily is best, even though you do not order daily. You do not have to stock as much and can get something quickly in an emergency.
- Does the supplier alter quality, quantity, and/or delivery-time standards? You do not want to deal with someone who has basic organizational problems.
- Where is the supplier located? Suppose you are in a rural area and your suppliers must travel more than an hour to reach you. Does distance affect the delivery schedule? What about the weather? Will your wine or beer travel for hours in the hot sun? Will snow and ice interrupt service?
- What resources does the supplier have? Is it a large and varied inventory kept well stocked, or a small stock that is continually being depleted? Does the sup-plier have temperature-controlled warehouse facilities? Refrigerated trucks?
- Does the supplier give proper and systematic care to goods in storage or in transit? Are wines kept at proper temperatures? Are bottles kept on their sides or upside down if traditional corks are used? Are draft beers and unpasteurized package beers kept refrigerated?
- Is the supplier's office and warehouse organized, clean, secure, and professional overall? (A visit to these facilities can tell you quite a bit.)
- Must you buy a certain minimum per order? Is there a maximum? Can you adjust your orders to meet these requirements? Is it worth it?
- Does the supplier extend credit, and what are the terms? (This is not often a negotiable point because of government restrictions.)
- Can you buy mixes and accessories from the supplier at advantageous prices and quantities?
- What is the supplier's lead time, or the time between ordering and delivery? (You must estimate consumption and order far enough ahead to compensate for the gap. The shorter lead time, the better.)
- How much consultation and training of your staff members is the supplier willing to give? (Some wine distributors are willing, for instance, to organize winery tours for buyers and key staff members, even to other states or countries.)
- Is the distributor's staff willing to participate in sales-boosting activities, such as arranging wine tastings and dinners? Is the company willing to donate products for charitable events?
- What other services does the supplier offer: e.g., blank order forms, promotional materials, 24-hour telephone service?

The number of suppliers that a bar deals with usually depends on the variety of products it wishes to carry. You should consider more than one supplier for each category (beer, wine, and spirits) because brands play such a strong role in your needs and because one vendor may be out of stock on one of your critical items. Not all suppliers carry all brands, by any means. If more than one supplier carries the same brand, go with the one that offers the best service and seems by all accounts to be running a profitable business. Avoid doing business with suppliers—at least, for the moment—if there are any signs of financial trouble.

7.2.2 Placing the Liquor Order

Once you know what you will need you can use the periodic order method. This involves selecting a fixed calendar of ordering dates, then calculate what your bar will use (and therefore, what will be needed) for each time period between order dates. A person in charge of the bar, such as the manager or bartender, then selects the best time of day for the beverages to be delivered, and the supplier should be able to comply.

An alternative system is the perpetual-inventory method. In this system the order dates are variable and the amounts are preset. Inventory cards list purchases and issues, along with other information, such as par stock, and the lowest amount to which the item must drop in inventory before it is reordered. Someone checks the cards regularly, notes what is ‘‘running low,’’ and orders it accordingly.

You must also develop a standard procedure for placing your orders. Theseprocedures will be influenced by size and sales volume. At one extreme is the multi copy purchase order typically used by the large organization. At the other extreme is the informal verbal (oral) order given over the telephone or in person to a visiting sales representative. But even the verbal order should have a complete paper record to back it up. Every record, formal or informal, should contain the following information:

- Date of the order
- Name of the purveyor (seller)
- Name of the salesperson
- Purveyor's phone number
- Anticipated date and time of delivery
- Items, brands, and vintages ordered
- Sizes of containers (bottle and case)
- Numbers of bottles or cases
- Unit prices (price per bottle for each item)
- Name of person placing order

There are four good reasons for keeping a written record of each order:

- It gives the person receiving the delivery the data needed to check it.
- It gives the person paying the bills the data needed for checking the bill.
- It gives everyone concerned with the order—whether buyer, receiving agent, storeroom staff, accountant, bar manager, banquet manager, or bartender—access to exact data.
- It minimizes uncertainty, misunderstanding, and argument.

REMEMBER

The invoice is the purveyor's response to the buyer's order. It reflects the information on the buyer's order sheet from the seller's point of view. It accompanies the delivery and must be signed by the buyer or the buyer's agent when delivery is received—which brings us to the second phase of the purchasing cycle.

In a small operation this record may simply be a memo of a telephone order written on a form devised by the house, or it may be an order handwritten by a visiting salesperson. The only one concerned may be the owner/manager who buys, receives, and stores the merchandise; stocks and tends the bar; and pays the bills. In a large organization, where responsibilities are divided among many departments, a formal, multi copy purchase order (P.O.) may be used, with the original going to the purveyor and copies sent to all concerned. Every purchase order has an order number (P.O. number), which is a key element in a network of paper records. It will be referenced on the purveyor's invoice and thus becoming the link between the two.

7.2.3 Receiving the Liquor Order

Technology is transforming today's wine wholesaler by automating transactions to an amazing degree. Cases of product may be tagged with radio-frequency identification (RFID) tags, making them easy for workers using handheld computers to find. These workers, known as pickers, can round up enough product to fill several orders at a time. Delivery trucks are outfitted with global positioning systems (GPS).The goals are to speed up large warehouse operations, minimize the margins for error, and eliminate breakage.

Despite all of the impressive technological safeguards the primary goal of the receiving process for the bar has not changed: to be sure that the delivery conforms exactly to what was ordered. The signing of the invoice by the purchaser has legal significance: It is the point at which the buyer, at least technically, becomes the ''owner'' of the merchandise. Therefore the delivery must be carefully checked be-fore the invoice is signed. The person you give this responsibility to must be some-one you trust, who has a good head for detail, and has been trained well for this assignment. There is no substitute for knowledgeable receiving personnel.

The first step is to check the invoice against the purchase order or memo. This must be an item-for-item check to see that the quantities, unit and case sizes, brands, vintages, and so on are listed as ordered and that the unit and case prices are quoted correctly. Then the math must be checked: the total costs per item, which are called extensions (the number of units multiplied by the unit cost) and the invoice total.

The second step is to check the delivery itself to see that it matches what is listed on the invoice. Each item must be checked as to quantity, unit, brand, vintage, and any other specification. Open cases should be verified bottle by bottle and examined for breakage, missing or broken tax stamps, and loose corks. Sealed cases should be examined for evidence of leaking bottles or weighed. The weight should agree with the weight printed on the case; a broken bottle will give a short weight. Beer should be checked for freshness by reading the pull dates on the containers, and for temperature by feeling the bottle or the keg. Kegs should be examined for signs of leakage. Their contents can be checked by weighing the keg, writing the weight on the invoice, and subtracting the tare weight, which is the weight of the empty keg, later.

The third step is to request a credit memo for any discrepancies between the order memo and the invoice or the delivery itself. The credit memo includes items invoiced but not delivered, items invoiced and delivered that were not ordered, wrong merchandise (sizes, brands), items refused (overage beer, broken bottles, missing stamps, swollen beer cans), wrong prices, and math errors. At this point the credit memo is usually a notation right on the invoice showing the item, problem, and amount, but it might be a separate credit slip on which the invoice date and number are written. In either case the credit memo must be initialed or signed by the delivery person, and it too must be checked for accuracy. Only when everything has been checked, settled, and initialed does the receiving agent accept delivery by signing two copies of the invoice, one for you and one for the purveyor.

7.2.4 Storage

The storeroom is the setting for the third phase of the purchasing cycle. This area performs three functions: security from theft, the physical care to maintain quality, and inventory maintenance and record-keeping. Computerized ordering has made it easier for bars and restaurants to order smaller amounts of goods more frequently, which may minimize the sizes of storage areas—but nothing will ever completely eliminate the need for storage.

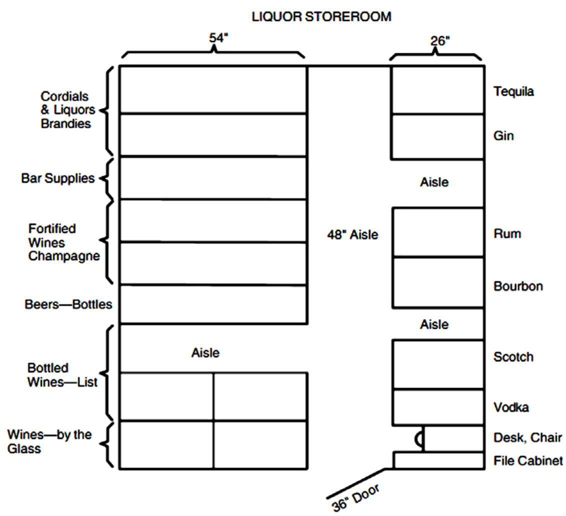
The first essential step to running an effective storeroom is to limit access: Make the room off limits except for specific, authorized personnel. Anyone withdrawing beverages does not enter the room; they must request what is needed from the storeroom staff or whoever has responsibility in a small operation. When open, the room must never be left unattended. If the person in charge must leave, even briefly, the door must be locked. This should be a substantial door with a deadbolt lock and only two sets of keys, one for the storeroom manager and one for emergencies, which is kept in the safe. Or it might have a combination lock that can be reset frequently, with only two people knowing the combination. If keys are used the locks should be changed often in case someone makes duplicate keys. Locks should always be changed when someone who has had keys leaves your employment.

Windows should be barred or covered with barbed wire. Alarm systems arefrequently used to protect against off-hour break-ins. Some of these systems depend on light or noise to scare away intruders or summon help; others alert police or a private security system directly.

An orderly storeroom is both a security measure and a necessity for efficientoperation. It should be divided into areas, each designed to stock a particular type of liquor. Each of these areas should be subdivided and clearly labeled so that each brand has a specially marked place. This also holds true for ancillary items, from cocktail napkins, to Champagne.

Never leave a case half empty; flatten empty cases and remove them promptly. It could be easy to steal hidden bottles along with the trash. Shelving should be made of wire, heavy, and well braced because liquor is heavy. Select shelf units that are easy to assemble and add to, and that can be fitted with casters so they can roll. Technology now allows so-called ‘‘smart shelves’’ that sense when a bottle or case has been removed and can be programmed to reorder from the distributor of the product. Sealed cases can be stacked on low platforms until you need their contents.

Wine storage takes special care since wines are perishable and must be protected from temperatures that are too high, too low, or fluctuating; vibration; sunlight; and excessive humidity, which causes mold to form around the foil cap. Wines survive best in a cool, dark environment between 50^0F and 70^0F (0^0C to 21^0C), with the ideal temperature being a constant 55^0F to 60^0F, which is known as cellar temperature. Wines that get too warm can leak through their corks and the seepage can stain or ruin the label.



Move wines as little as possible and when you do handle them gently. Agitatinga wine may upset both its chemistry and its sediment, making it un-servable until the sediment settles again. For this reason newly imported wines should rest for30 to 45 days before being served. However, since wines have limited life spans, rotating the stock becomes particularly important. Wine racks are the best places to store wine but not everyone has the room or money to purchase them. You can store wines on their sides or upside down in their sealed cases, but be careful not to stack them too high. More than five cases stacked on top of each other causes too much pressure on the necks of the upside-down bottles and can cause them to break. Also, the sediment collects inside the bottle's neck, sticking to the cork and making it difficult to extract when the wine is finally opened. Places not to store wine? Near loading docks, the dish room, the kitchen, air-conditioning and heating-exhaust ducts, and never under stairways.

Beer has the most limited shelf life of all. Canned and bottled beers should be stored below 70^0F (21^0C) in a dark place and their pull dates should be checked periodically. Draft beers and some non-pasteurized canned or bottled beers should be kept refrigerated; ask your supplier about optimum storage conditions for these. Draft beer must be kept at an even 36^0Fto 38^0F (2.2^0C to 3.3^0C) and should be used within30 to 45 days. The best system of rotation has a handy acronym, FIFO, which means first in, first out.

DID YOU KNOW ?

Most breweries have adopted pull-date systems, much like other perish-able goods, with a cutesy new name: the ''born-on date'' (BOD). Anheuser-Busch uses the date that the beer was packaged and states that its shelf life is ''110days'' after that. Other mega brewers list an expiration date.

7.2.5 Inventory

The beverage inventory, which is the amount on hand at any given time, is of central importance to the purchasing function. The buyer must be able to determine exactly what is immediately available and the rate at which it is being used in order to make intelligent purchasing decisions. In addition to storeroom records other means of keeping track of total inventory are needed. There are two reasons for keeping a constant check on inventory. One is to pinpoint losses quickly in order to put a stop to them. The other reason has to do with purchasing. If you have lost stock due to theft, breakage, or error, you must buy stock to replace it so that you can serve your customers. Therefore you need to know what you really have on hand in order to plan each purchase.

Physical Inventory

The only accurate way to know what you have on hand is to take a complete physical inventory, which means counting each bottle and keg on a regular basis. Ideally you will perform a physical inventory weekly and again at the end of the accounting period. If possible the inventory should be taken by persons who do not buy liquor or handle it on the job. As a double check it is best to have two people working together, one counting and the other writing down the count.

The liquor at the bar is also part of inventory until it is sold, and it too is counted in an end-of-the-month physical inventory. It is inventoried in the same manner as the storeroom inventory except that there are opened bottles to be counted.

The simplest way to measure the contents of opened bottles is to estimate each bottle by sight and count the contents in tenths. Thus, a full bottle is 10/10, a half bottle is 5/10, and an empty bottle is 0/10. This gives you an approximate amount, of course, but it is close enough. If you have a metered pouring system you have a very accurate way of counting. The system counts the drinks that it pours. You multiply the count by the size of the drink and compare this with what is left in the partly used bottle. You have to count the liquor in each line from bottle to dispensing head as part of the inventory. The manufacturer's representative should give you this capacity at the time that the equipment is installed.

One tool to speed the inventory process is the bar-code scanner.

Since practically every item is labeled today with a Universal Product Code (UPC), a hand-held model scanner can be used to scan each UPC label and instantly download its identity to a computer. A compatible scale can be used that is also able to read the UPC label, compute the bottle's total weight, subtract the tare weight (the weight of the identical bottle when empty), and the weight of the pourer if one is used on this particular bottle. Automatically the scale calculates the net weight and converts it to ounces. This method is precise enough to provide real cost controls for a manager. It is a computerized way to compare the volume of beverages the POS system says should have been used (based on sales) to actual usage (based on the bar-code scanner's readings). No matter which method is used the inventory must be taken all at once, from start to finish, and it must be done when the bar is closed so that nothing changes while the count is being taken. Weekly inventories of individual bars or the storeroom may supplement the overall end-of-the-month count.

Perpetual Inventory

Another way of providing inventory information is to com-pile ongoing daily records from invoices and requisitions, adding each day's purchases and subtracting each day's issues for every item in stock.

At any point in time the perpetual inventory is a paper record that should indicate exact quantities of every item that you have on hand. It does not tell you what you really have; only a physical inventory can do that. A perpetual inventory's primary function is to provide a standard against which a physical count can be measured item for item at any given time. If everything is in order the two inventories should agree. If separate records are kept on bin cards they should also agree: They, too, are a form of perpetual inventory.

The more inventory you have the more important it is that a perpetual inventory be kept. Since it should also clearly reveal a product's depletion rate it has the added benefit of making the ordering process more accurate. It also greatly assists in detecting employee theft. Finally it assists you in meeting your state's licensing requirements to maintain accurate records of the bar's alcohol purchases.

7.3 BEVERAGE CONTROLS AND SERVICE PROCEDURES

Alcoholic beverages must not be self-served. There must be a beverage server(s) throughout the event responsible for the dispensing of alcoholic and non-alcoholic beverages to those in attendance. A secret shopper measures and compares customer service levels, spots trends, and provides accurate feedback in the form of mystery guest hotel, restaurant, and spa reports. Managers view secret shopping as an independent verification of what is working and what needs fixing. There are several companies on the Web that offer these types of services to hotels and restaurants.

While you and the management team set up procedures that establish control over your inventory assets, your servers and bartenders are out there on the front line, making sure your guests' needs are heard and answered. Again, you are balancing the needs and preferences of your clients with your profit-making goals. Both control in the back of the house and service in the front of the house can help you achieve these goals.

The starting point in beverage control and sales is the establishment of portion size control (PSC) and standard drink recipes (SDRs). All employees and managers must work to see that these two controls are followed. Without them, you will not be able to evaluate valid data or to control costs.

The objectives of these controls are:

- to monitor and identify deviations from standard operating procedure (SOP) so that you can quickly correct the situation.
- to aid the manager in compiling cost data, which is used to compare and analyze potential versus actual cost.
- to provide a basis for consistency.
- to set ingredient quantity guidelines.
- to simplify and standardize training information.
- to serve as a continuous source of reference for everyone involved in service.
- to act as a watchdog for combating both internal and external theft.

7.3.1 Portion Size Control (PSC)

Portion size control is the standardization of beverages in order to control both quantity of liquor and quality of the drink. It is vital to create a method for pouring exact portions because you are often dealing with numerous bartenders and possibly high turnover. The point here, as always, is consistency. This is undeniably important to building a client base. New customers expect your Bloody Mary to taste like others they have had, and repeat customers expect it to taste like the last one they ordered from you.

Meeting customer expectations may be even more important for good profit than setting your drink prices correctly. Sales price multiplied by sales volume produces your revenue. You cannot build volume with drinks that do not meet customer wishes consistently. To achieve this, you need portion size control (PSC) for each and every drink. When PSC is in place and followed by the whole staff, the customer will get the same drink no matter who makes it.

Another advantage of consistency is accurate control of the amount of liquor poured. If you control the quantity of liquor, you also control costs. In this way you can maintain your cost to-sales ratio and protect your profit. To achieve all of this, standardize three elements of each drink: size, recipe, and glass.

Size

There are three common methods of measuring liquor. The first is to use an automated pouring device, with which the major ingredients are measured and dispensed through a handgun or specialized pourer. These shut off at pre-established amounts per drink. A second way is for the bar staff to pour drinks using an established jigger size and to fill them only to the line on the jigger. A third method is to free-pour. This is a subjective form of measurement that involves turning the bottle, with a pourer in place, and pouring upside down at full force. The bartender counts in his or her head; to pour an ounce, for example, he or she might count "One, two, three" or "Ten, twenty, thirty." This method is not recommended because it is the least accurate; it is only as consistent as the bartender. Free-pouring varies between bartenders and from day to day.

Computerized dispensing systems are used for portion control, perpetual inventory, standard recipe controls, and accuracy in guest charges. These systems have an electronic control device attached to each bottle to monitor and control the amount of alcohol dispensed. Beverages are poured accurately each time. Some systems have check-processing capabilities that ensure that the guest is charged properly for every drink. Taking control over the pouring of beverages is one of the most critical decisions a manager can make. The following are some of the advantages of using computerized dispensing systems:

- Less time is needed to train bartenders.
- There is less spillage and less breakage.
- Prices are preprogrammed into the machine, so pricing mistakes are eliminated.
- Standard recipe pour amounts are consistent and accurate.
- The system deters dishonest employees from stealing or giving away free drinks.
- Operational control of the bar is improved.
- You have an accurate accounting of the sales and profitability of each item.
- The system produces the sales, inventory, and employee reports you need.

There are several automated dispensing systems on the market; not all of them provide you with every advantage mentioned above. The biggest criticism is that the systems can break down on occasion. The following are some other disadvantages:

- Because of the way beverages must be stored, guests cannot see the bottles or the brand names at the bar. Ambience and brand promotion are lost.
- Most systems cannot mix all possible drinks that are available.
- Most bar operations do not have a contingency plan for use when the computer breaks down. Therefore, a malfunction can literally shut down sales until manual operation is installed.
- A dishonest employee may be able to beat the system by breaking it.

As a manager, you must weigh these advantages and disadvantages in light of your own operation. You should research the available models and try them out, weighing your operation's needs against each system's functions. Whether or not you choose an automated dispensing system, you will still need to establish adequate PSC standards.

7.3.2 Standard Drink Recipes (SDRs)

A successful standard drink recipe, or SDR, is a carefully calculated relationship of ingredients, with further calculations and standards for the glass, ice, and garnish. This is one area in which the chef's expertise can play an important role; it is advisable to combine the chef's cuisine with a suggested drink that goes well with the food. Many diners are calorie-conscious, however, so chefs may need to keep this in mind when suggesting drinks. Twelve ounces of regular beer contains 150 calories; 5 ounces of wine contains 100 calories; and 1.5 ounces of 80-proof distilled spirits contains 100 calories.

There are many bar books to refer to when planning a drink menu and making recipe calculations. Simply write down the exact recipe for each drink you serve. Then, train the bar staff to follow the recipes consistently; this way, they will produce a consistent product no matter who tends the bar.

Prepare each drink and take its photograph; compile these photos into a visual presentation manual for your bar staff. The following information should be included:

- The amount of the primary ingredient to be poured (which becomes the jigger size you need to make available to your staff)
- The other ingredients and their amounts or proportions to the major ingredient
- The size of the glass to be used
- The amount of ice in the glass
- The amount of garnish and its arrangement on the glass

The ice in the glass is a key ingredient in any drink made with a carbonated mixer or juice. Its function is to chill the drink and control the proportion of liquor to mixer by taking the place of liquid in the glass. The ice goes into the glass first. The more ice you use, the less mixer goes in the drink.

7.3.3 Getting Specific: How the Controls Work

Your costs will vary widely when different amounts are poured. Review the information in below figure. From a 33.8-ounce (1-liter) bottle of vodka, you can get 33.8 one-ounce servings, 27 one-and-one-quarter ounce servings, or 22.5 one-and-a-half-ounce servings. Let's assume the bottle price was $12 and you are selling one drink for $3.

Size	Number of Fluid Ounces	Yield in 1-Ounce Drinks	Yield in 1.25-Ounce Drinks	Yield in 1.5-Ounce Drinks
Full Bottle	33.8	33.8 portions	27.0 portions	22.5 portions
Half Bottle	16.9	16.9 portions	13.5 portions	11.3 portions
1/10 Bottle	3.38	3.4 portions	2.7 portions	2.3 portions

Master Beverage Pour Cost Sheet

You can use below figure to determine the ingredient costs for your beverages and to keep them all in one place. The data must be accurate to be relevant. If you have more than one outlet, use a separate form for each, as you may have different pricing strategies from one outlet to another. Use and update these forms for each outlet. The information gives you a ready perspective on costs across your beverage offerings.

Product Number	Item Name	Size of Item	Portion per Bottle	Portion Cost	Mixers Cost	Total Cost	Selling Price in $	Cost %

Other Beverage Controls

The manager is the custodial authority of the beverage storeroom. He or she will be monitoring the stock of each item at all times. When everything is systematically in place, he or she can easily notice if something is missing. One method to systematize your storeroom is to use bin cards, including a unique bin number for each item.

A typical bin card shows the brand name, bottle size, quantity on hand, and bin or inventory code number. The minimum or maximum stock levels may also be recorded on the cards, as this information makes it easier to determine purchasing needs. The card is then affixed to the appropriate shelf. Bin cards note each entry and exit of a product. They are also very useful in a perpetual inventory system. The amount of stock delivered is added to the quantity on hand, and the amount issued is subtracted. The number of bottles shown on the bin should always agree with the actual number on the shelf. Storeroom personnel will need to spot-check inventory against the bin cards to help keep track of inventory. The information on the card, then, provides reliable rates of inventory use.

Another aspect of beverage control is eliminating the confusion in bottle sizes, spelling of names, and different brands. The purchasing manager should identify every kind of beverage carried in the restaurant or bar by means of a bin number or item number. Each type of beverage is assigned a block of numbers. For example, in a four-digit system, gin might be 1000, rum 2000, tequila 3000, and so on. Then particular brands would fall into those categories— for example, Tanqueray is 1001, Beefeater's is 1002, and so on. This system makes storage, inventory, par stock, and ordering procedures more organized and standardized. Bin or item numbers are used in a beverage control system for the following reasons:

- To simplify and standardize beverage control procedures and forms
- To facilitate purchasing, storing, requisitioning, and recording of physical inventories

- To provide precise numerical product descriptions to be used in inventory and purchasing control systems

The restaurant or bar par stock list is one of the most important procedural controls in a beverage control system.

A copy of each par stock listing should be located in the outlet itself; there should also be one in the manager's office and one in the beverage storeroom. Each outlet is then issued only enough beverages to meet those par numbers. The purchasing clerk should never issue any beverage product in a quantity greater than the par value without special authorization by the manager. This might be necessary if the par value is being modified because of an increase in the outlet's business activity. For the most part, however, issuing over par will not be necessary, and this control provides a strong basis for beverage cost reckoning. Establishing par levels for each outlet, and sticking to them, can even eliminate the need for monthly inventory.

Item	Number to Always Have on Hand (par stock)
Shotz Beer six-packs	6
Applewood Creme de Menthe 1 liter	1
Reposado Tequila 750 ml	3
Bumblebee Gin 1 liter	2
Haberdash Peach Schnapps 750 ml	1

The person in charge of inventories should conduct regular spot checks to be sure that par stock is maintained. If these levels are in place, you need only multiply the par stock by the purchase price to determine inventory value figures. This system also does the following:

- Assures adequate supply
- Minimizes the physical inventory kept in stock, which helps reduce the opportunity for theft and maximize cash flow
- Reduces the number of trips to the storeroom and thus improves the labor productivity of the bartender and purchasing clerk
- Facilitates requisitioning when empty bottles are counted for return
- Provides an immediate inventory accountability by all personnel
- Discourages a bartender from bringing in his or her own bottle and selling its contents; the outlet-coded sticker or stamp system will also help to prevent this form of pilferage

For a par stock listing to be worthwhile, the par stock should be spot-checked on a random, unannounced basis in each outlet at least once per month (in addition to the inventory process). These spot-audits, however, are no substitute for direct, hands-on involvement by the manager who has supervisory authority over the bartender. Outlet managers should also understand the par stock system and see that it is enforced.

Color-Coded Outlet Stickers or Stamps

Color-coded outlet stickers or stamps should be placed on liquor bottles when they are requisitioned from the beverage storeroom. These stamps will identify all bottles as company issue, and will also indicate to which outlet they were issued to provide a backup check of where the bottles go. This can prevent theft and can also keep staff from trading bottles between outlets without documenting the transfer.

To enact this procedure, the storeroom clerk should mark all the liquor bottles for a given outlet with some type of color-coded outlet sticker or stamp, as established by the purchasing manager. This sticker or stamp should be placed on the back label of the bottle, rather than on the bottom; this facilitates recognition during inventory-taking and spot-checking procedures. The stamps should be impervious to removal. During any random check, every liquor product in an outlet should match its par stock, and all the full, partial, and empty bottles should have that outlet's identifying color sticker or stamp on them.

Waste, Breakage, Spoilage, and Spillage

Waste is a common occurrence in the food and beverage industry. This does not mean it should simply be accepted as tolerable. Your job is to minimize its occurrence and to control procedures when it does occur. Consider the case of breakage. If a bottle is broken or spoiled in storage or at a bar, the manager or bartender should return the broken bottle neck or spoiled product to the person in charge of the inventory. This inventory control person should complete and sign a requisition for the item and return the requisition to the manager or bartender, who will then submit the signed requisition with the daily order. This provides an authorized paper trail of the variances that inevitably occur, so that patterns or problem areas can be tracked.

The requisition, together with the spoiled or empty bottle or the broken bottle neck, is returned to the beverage storeroom for replacement. The broken bottle neck is discarded. The requisition should be clearly marked as breakage. From an accounting perspective, the bar should bear the cost of breakage. If the quantity in question is more than a single bottle (for example, a case falls from a pallet or mechanical lift), the manager should be notified to verify physically that this breakage has occurred.

When a bottle of wine has been sold to the guest and then is judged to have spoiled, the sale of this spoiled product should remain documented through the POS system. It may be channeled to a special spoilage account set up by the manager or simply voided. For purposes of requisition, a record of the void slip will serve as proof.

Spoilage involves either ingredient spoilage or a guest who mentions dissatisfaction with the quality of a drink. Spillage, on the other hand, is what happens when a server spills all or part of a drink. The server may reorder the same drink and process a separate beverage charge through the POS system. The check should then be settled or closed, with all explanatory notes included and signed by the outlet manager as spillage or dissatisfied guest. The bar should bear the cost of spillage; spoilage also should be charged to the outlet if the item could not be returned to the vendor for credit. The manager should complete a breakage, spoilage, and spillage report to justify why actual cost is different from potential cost.

Cash bar Control

In a cash bar, a guest pays for each drink as it is ordered. This type of service is often used in the case of banquet events like weddings or large parties. Cash bars are often carried out in a remote location, such as a banquet room or an outdoor deck. However, it should operate with the same type of controls as the main bar. Because such remote locations often preclude the use of automated dispensing systems and POS access is unlikely, pouring methods should be established to monitor and account for all revenues collected. One way to account for sales and inventory, and to ensure that there is no missing revenue, is to use a cash bar worksheet as in below figure.

Smith Wedding Items	Date: April 5th		Location: Restaurant Deck	
	A Beginning Inv.	B Additions	C Ending Inv.	D A + B − C
Vodka Blitski	1	2	1	1 + 2 − 1 = 2
Tequila Rodeo	2	0	2	2 + 0 − 2 = 0
Gin Parker	3	1	1	3 + 1 − 1 = 3

The procedures and policies you develop for cash bar control will help to prevent loss of cash due to theft. In addition, the following controls should be incorporated into cash bar systems:

- *Ticket or guest check control systems*. Some operations have a cashier sell tickets that can be given to the bartender in exchange for a drink. This frees the bartender from handling cash, facilitates better service, and allows tighter controls. The number of drinks consumed should match the drink tickets sold and collected. When there are void transactions where the drink tickets are sold, have the manager authorize them and make the reason for the void clear for reporting purposes.

- *Recording sales*. It may be cost-effective to use a cash register for cash bar events. This saves hours of manual paperwork time, frees employees from memorizing item prices, and facilitates service procedures. The drink prices can easily be preprogrammed into the register.
- *House bank*. The bank is an amount of money with which the employee begins the shift. The size of the bank should depend on the expected amount of business. Servers may carry individual banks, or the bartender may collect all cash received. Choose a method that meets the needs of your operation.

In a hosted bar, the host pays for all items consumed. The price, agreed upon ahead of time, is applied to the amount of services or food and beverage consumed. When the price is per bottle, a special par stock is set up just for that function, and the amount of food or beverage consumed is computed by subtracting the ending inventory from the beginning inventory (par inventory plus any additions during the event). Generally, there is no cash for staff to steal in a hosted event, because payment for services and goods is not made directly to them; however, adequate record controls must still be established for billing and accounting.

7.3.4 Banquet Beverage Storeroom Procedures

Banquet beverage use brings up special issues that cannot be reconciled through standard procedures. A banquet beverage storeroom is commonly established for banquet service in large operations, because this type of service is markedly different from any outlet service. The banquet manager should restock from the purchasing beverage storeroom as needed by using a requisition form. This form may be preprinted with all the beverage products you carry. The bartender would then only need to enter the quantity needed.

For each individual banquet, a special banquet beverage requisition is completed. Products should be issued from a separate banquet beverage storeroom to the individual service bars. After the function, all unused liquor should be returned to that storeroom. If you have enough banquet business to have standard issues to banquet rooms, these can be entered on a requisition form, and they should be charged by function. A standard issue is a repeated restocking of products to par levels, just as in a regular outlet. Every item issued, minus the ending inventory, should be charged to that function. In most cases your company will establish a contract with the banquet client prior to the event. The charges can then be reconciled to that contracted price.

7.3.5 Beverage Cost Variance

When you compare your actual cost to your potential cost, the difference between them is called the variance. This amount will probably vary from month to month, due to the ever-changing nature of the business. Assuming that control procedures are followed and there are no significant changes in the sales mix, the beverage variance percentage should not be more than 1 % off from the calculated potential cost.

Calculating potential cost for your beverage business is essentially the same as doing so for food. Begin by determining the number of drinks per bottle and multiplying this by the selling price per drink. This is the potential sales per bottle.

A 1-liter bottle will yield approximately 27 drinks at 1.25 fluid ounces each. If the drinks are sold at $3.75 each, the potential sales reach $101.25 for one bottle. If your cost for that bottle was $22, you need only divide that cost by the potential sales to reach the potential percentage. In this case it is 21.7 %.

But perhaps you do not sell all drinks made with a particular liquor at the same price or with the same amount of alcohol. In this case, you will need to determine weighted averages for both drink size and selling price. Let's take a $14 bottle of gin as an example, as shown in below figure.

Name of Drink	FZ of Gin Used	Selling Price (& number sold last month)	Total Sales	Total Ounces
martini	1.5	$3.75 (16)	$60.00	24
gin & tonic	1.25	$3.00 (150)	$450.00	187.5
gin fizz	1.0	$2.75 (39)	$107.25	39
gin on the rocks	1.5	$3.50 (110)	$385.00	165
		Total sold: (315)	Total: $1002.25	Total: 415.50 FZ

The number of ounces used (415.5) divided by the number of drinks sold (315) gives you your average drink size, 1.32 ounces. This number, divided into your bottle size (1 liter or 33.8 ounces), equals the average number of drinks per bottle, 25.6.

Next, find your average selling price by dividing total sales by total number of drinks sold. Your average selling price is $3.18. Multiply this average price by the average number of drinks per bottle. In our example, this is $3.18 3 25.6 for a total of $81.41. This is your potential sales value per bottle. The potential beverage cost is equal to the cost divided by the potential sales, or $14 4 $81.41. We get a potential beverage cost percentage of 17.2.

Now you need to determine your actual sales revenue. Simply multiply the numbers of each drink sold by the drink's selling price, and total the result. In our example, the total revenue was $1,002.25. Your POS reports should show you the actual number of drinks sold at each selling price and the sales mix of each category.

The next step is to determine the actual beverage cost percentage. The formula for calculating the beverage cost for a specified period is as follows:

Beginning Inventory + Purchases - Ending Inventory = Cost of Product Consumed

In food and beverage operations, which commonly transfer food products such as juices and garnish fruit to the bar, adjustments to the gross cost need to be made. Similar adjustments must be made for any products transferred from the bar to the kitchen, such as wine for cooking. In these cases, the gross beverage cost would be adjusted as follows:

Cost of Product Consumed + Transfers to Bar - Transfers from Bar = Net Cost of Product Consumed

Using our example, assume the net beverage cost was $180 and the total beverage sales was $1,002.25; the actual beverage cost percentage would be $180 divided by $1,002.25 5 18.0 %. Now we can compare the potential cost—at 17.2 %—with the actual 18 % we calculated.

Compare these two numbers to check for significant variations. When you have added up many items across food and beverage categories, however, it can be hard to see where problems lie. This is made worse if your company has multiple outlets, as we illustrate in the example below. In addition, companies that do not have a perpetual inventory system tabulated by outlet or that have not computed their cost by outlet may find it difficult to identify exact causes of variances because outlets are different and may have varying stock and pricing.

7.3.6 Service Procedures

You have seen the unique challenges facing the manager in the operation of an outlet and in the sale of beverages. The purpose of the following sections is to set up standard operating procedures (SOPs) to aid you and your employees in training and coaching. No training or staff system is perfect; you may need to refine what is mentioned here to it your company's needs. Without the consistent and accurate cooperation of your staff, however, all of your controls may be worthless. Be sure to include comprehensive training and ongoing coaching for your staff as an operational goal and necessity. Below we provide information that you can use in training your service staff; it is written in a style that speaks directly to servers and bartenders. Be sure to emphasize that these are the procedures and behaviors that you expect your staff to perform.

When Guests Arrive

- Greet guests with a welcome as they come into the room. If you are busy, acknowledge them with a word or a smile and establish eye contact. If guests know that they have been recognized, they will not mind a short delay in service. No matter where you are in the room, always keep your eye on the other tables.
- Always face the tables while standing at the bar.

Serving Our Guests

- Always be positive. "May I get you another cocktail?" or "Would you care for another round?" is preferable to "Is that all?"
- Place cocktail napkins in front of the guests with any logo, emblem, or written material facing them.
- If you know the guests, call them by name. If they are regular patrons, remember their favorite brand or cocktail and how they like it.

- Suggest one or two featured beverages to the customer when ordering. Use up-selling techniques to encourage customers to purchase more premium products.
- Serve cocktails as soon as possible.

Pouring Drinks

- Place the pour spout in the bottle in such a way that the label is turned toward guests seated at the bar. This allows guests to see what is being poured.
- Never overfill a glass so that it spills on the bar or on the guests when they attempt to drink the cocktail. Never pick up a glass—clean or dirty—by the rim. Always hold stemmed glasses by the stem.
- Strictly adhere to the company pour policy in accordance with recipes. Use pour control devices on all liquor bottles, except odd-sized liqueurs or cordials.

Presenting a Check to a Bar Guest

- Always process the order through the POS system, if available.
- Always place the guest check in front of the bar guest at the same time the cocktail is served. This is very important.

Service Standards We Expect

- Ensure that the table is maintained well at all times. For example, remove soiled napkins and replace used ashtrays. Used ashtrays should always be replaced with a clean one.
- Be alert for minors. If there is the slightest doubt, ask for identification; if the person cannot produce an ID, or if you have reason to distrust the ID he or she provides, you will have to refuse service courteously.
- Never argue with a guest. Call the manager to settle disputes.
- It is every staff member's responsibility to refuse service to an intoxicated person. If there is a problem, call the manager.
- Be alert to the guest's need for another cocktail.
- Talk, but be a good listener. Do not join conversations, and never give the impression of listening in on a conversation. Be attentive without being overly familiar.
- If you make an error with a cocktail, rectify it at once. Make the correction without question, and clearly dispose of the mistaken drink. Notify the manager and give a copy of the spillage report to the accountant.

Collecting Payment

- Do not attempt to collect payment until guests indicate that they are ready to pay or to sign the check. If the guest pays by credit card, note his or her last name and expiration date on the guest ticket. If it is a hotel room charge, have the guest print and sign his or her name and room number; then match the information on the registered guest list to the name and room number on the check.
- Finalize the closed check in the POS system. Immediately return change or a credit card receipt to the guest along with the check stub receipt.

When Guests Depart

- Express your appreciation and invite guests to return.
- Tables should always be wiped down with a damp cloth. Wipe crumbs from chairs, replace ashtrays, and replenish matches. Tidy the floor if necessary.

Our Restaurant Standards

- Always be courteous and helpful to fellow employees. This will be noticed and appreciated by guests.
- Pay particular attention to personal appearance and grooming, and wear a clean uniform.
- When leaving the floor for any reason, tell the room manager or the bartender first.

SUMMARY

- From an accounting and financial standpoint, a restaurant inventory is the dollar value of the food and beverage items that are held in storage. While in storage, the inventoried items are not considered a cost until used or sold. Just like cash, food and beverage inventory is a company asset. Unlike cash, however, inventory values may decrease since food and beverage items are perishable and subject to spoilage and theft.
- Food and beverage services sector contributes a great deal to the profits in hospitality industry. With the increase in importance of business meetings, a range of personal and social events, a large number of customers visit catering establishments frequently. The food and beverage professionals tirelessly work to intensify customers' experience through their service.
- Food and Beverage Service operations involve a multitude of activities which engage the staff right from purchasing raw material, preparing food and beverage, keeping the inventory of material, maintaining service quality continuously, managing various catered events, and most importantly, analyzing the business outcomes to decide future policies.
- The purchasing department in F&B Services is responsible for purchasing, storing, and issuing the supply of raw food items, canned/bottled beverages, and equipment.
- The purchaser is responsible for purchasing a product. He studies the market, and analyzes and selects suppliers, wholesalers, and the contemporary market prices. He then liaisons with suppliers and wholesalers to get good material at fair price and purchases the required commodities by following appropriate purchase procedures.
- The alcoholic beverages are an investment in income-producing stock and there are many facets to making the best investment for the least money. Another part of the answer is that the purchasing and record-keeping processes are critical to other aspects of the business.

MULTIPLE CHOICE QUESTIONS

1. **Fast-food restaurants are able to keep prices low because:**
   a. they use a limited menu and provide no table service.
   b. they do not need to train staff, and the work is easy.
   c. they use poor quality food products.
   d. they have fewer seats than other restaurants.
2. **Restaurants that serve homestyle food, provide booster seats and highchairs, and fast, friendly table service are most likely:**
   a. franchised restaurants.
   b. fast-food restaurants.
   c. specialty restaurants.
   d. family-style restaurants.
3. **What is the main difference between commercial food services and non-commercial food services?**
   a. The size of the establishment and the clientele differ.
   b. Non-commercial food services are not permanent, whereas commercial food services are.
   c. Non-commercial food services are found in businesses whose focus is not food.
   d. In commercial food services, the same company owns and manages the restaurant, and in non-commercial food services, one person owns the restaurant and another company manages it.
4. **The decision making responsibility in an F&B establishment rests with the managers.**
   a True
   b. False
5. **Beverage is a liquid for drinking; drink; usually applied to drink artificially prepared and of an agreeable flavor; as an intoxicating beverage.**
   a. True
   b. False

Review Questions

1. Explain the types of food and beverage services.
2. Describe the operations of food and beverage services.
3. Focus on purchasing, receiving, storage, and inventory of beverages.
4. Discuss about beverage cost variance.
5. Write short notes on:
    - Non-alcoholic beverages
    - Alcoholic beverages

Answer to Multiple Choice Questions

1. (a) 2. (d) 3. (c) 4. (a) 5. (a)

REFERENCES

1. 'British Beer and Pub Association (BBPA) Statistical Handbook: a compilation of drinks industry statistics' (2008). London: Brewing Publications. Available at: http://capitadiscovery.co.uk/bournemouth-ac/items?query=beer+and+pub+association+statistical+handbook&sort=publishedyear:d.
2. 'Caterer' (no date). Available at: http://search.ebscohost.com/login.aspx?authtype=ip,shib&custid=s7547708&direct=true&db=edspub&AN=edp15979&site=eds-live&scope=site.
3. 'Decanter: the world's best wine magazine' (no date). London: Prestige Magazines.
4. Adams, M. R., Moss, M. O. and McClure, P. J. (2016) *Food microbiology*. 4th edition. Cambridge: Royal Society of Chemistry.
5. *British Hospitality Association (BHA)* (no date). Available at: http://www.bha.org.uk/.
6. Brotherton, B. (2008) *Researching hospitality and tourism: a student guide*. Los Angeles: SAGE. Available at: http://lib.myilibrary.com?id=355461.
7. Brotherton, B. (2015) *Researching hospitality and tourism*. Second edition. Los Angeles: SAGE.
8. Campbell, J., Foskett, D. and Ceserani, V. (2008) *Practical cookery*. 11th ed. London: Hodder Education.
9. Cottrell, S. (2015) *Skills for success: personal development and employability*. Third edition. Basingstoke: Palgrave Macmillan.
10. Cousins, J. A., Lillicrap, D. R. and Weekes, S. (2014) *Food and beverage service*. 9th edition. London: Hodder Education, an Hachette UK Company. Available at: http://lib.myilibrary.com?id=637283.
11. Cousins, John A., Foskett, David and Pennington, Andrew (2011a) *Food and beverage management: for the hospitality, tourism and event industries*. 3rd ed. Woodeaton: Goodfellow Publishers. Available at: http://lib.myilibrary.com?id=327498&entityid=https://idp.bournemouth.ac.uk/oala/metadata.
12. Cousins, John A., Foskett, David and Pennington, Andrew (2011b) *Food and beverage management: for the hospitality, tourism and event industries*. 3rd ed. Oxford: Goodfellow.
13. Davis, B. (2011) *Food and beverage management*. 5th ed. Oxford: Butterworth-Heinemann.
14. Dittmer, P. and Keefe, J. D. (2009) *Principles of food, beverage, and labor cost controls*. 9th ed. Hoboken, N.J.: John Wiley. Available at: http://lib.myilibrary.com?id=176665.
15. *EPICURIOUS: THE WORLD'S GREATEST RECIPE COLLECTION* (no date).

16. *Faculty of Management Resource Guides (including Referencing)* (no date). Available at: http://libguides.bournemouth.ac.uk/prf.php?account_id=91536.
17. Foskett, D. and Paskins, P. (2011a) *The theory of hospitality & catering: for levels 3 and 4*. 12th edition. London: Hodder Education. Available at: http://lib.myilibrary.com?id=529453.
18. Foskett, D. and Paskins, P. (2011b) *The theory of hospitality & catering: for levels 3 and 4*. 12th ed. London: Hodder Education.
19. Foskett, D., Ceserani, V. and Kinton, R. (2007) *Ceserani and Kinton's the theory of catering*. Eleventh edition. London: Hodder Arnold. Available at: http://search.ebscohost.com/login.aspx?authtype=ip,shib&custid=s7547708&direct=true&db=nlebk&db=nlabk&site=ehost-live&scope=site&AN=697685.
20. Foskett, D., Rippington, N., Paskins, P. and Thorpe, S. (2015) *Practical cookery: for level 2 NVQS and apprenticeships*. 13th edition. London: Hodder Education. Available at: http://lib.myilibrary.com?id=797597.
21. Getz, D., Robinson, R., Andersson, T. and Vujicic, S. (2014a) *Foodies and food tourism*. Oxford: Goodfellow Publishers. Available at: http://search.ebscohost.com/login.aspx?authtype=ip,shib&custid=s7547708&direct=true&db=nlebk&db=nlabk&site=ehost-live&scope=site&AN=854504.
22. Ninemeier, J. D. and American Hotel & Lodging Educational Institute (2009) *Planning and control*

INDEX

Level: Beginner to Advanced
Subject: Hospitality and Tourism

Restaurant Financial Basics

One of the most effective tools any restaurant has is the ability to track food and beverage sales on a daily basis. A daily business review can help analyze sales trends, payroll costs, customer counts, and predict future sales. More than half the restaurants that open fail in their first two years of service. This is a known fact in the restaurant industry and one of the main reasons the industry is so feared by new entrepreneurs. While it is true that the restaurant space is ruthless, there are still those who open up and not just survive the business but also lead the industry. What enables them to do it? While multiple factors contribute to the success of a restaurant, managing the restaurant finances the right way is a significant reason behind it. Most restaurants lack an excellent financial management system. Usually, first-time restaurateurs are so focused on arranging the capital for opening a restaurant that they forget about the working capital, that is, the money that would sustain the business, until the restaurant reaches its break-even and starts generating profit

This book is designed to provide a basic overview of the operation of a restaurant from a financial perspective. The book presents understanding of the basics of financial management for food service, how restaurants create budgets, manage expenses, pay employees and more.

ISBN 978-1-98467-653-5

BIBLIOTEX
Digital Library

www.3ge-learning.com
email: info@3ge-learning.com