



UNDERSTANDING HOSPITALITY ACCOUNTING I

Second Edition

Raymond Cote

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Raymond Cote, CPA



EDUCATIONAL INSTITUTE
of the American Hotel & Motel Association

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Preface

Over the years, the hospitality sector has been searching for a financial accounting text which combines a clear and straightforward approach with an awareness of the industry's unique requirements. The publication of the *Understanding Hospitality Accounting* series provides an affirmative response to this search by relating fundamental accounting principles to the hospitality industry in a practical and user-friendly mode. In presenting accounting principles and procedures, the series assumes no previous background in bookkeeping or accounting.

The series is composed of two volumes: *Understanding Hospitality Accounting I* and *Understanding Hospitality Accounting II*. This, the first volume, presents the accounting concepts and procedures used in the accounting cycle. The second volume provides in-depth coverage of more advanced accounting topics.

The authoritative source for the series is the *Uniform System of Accounting for Small Hotels, Motels, and Motor Hotels* published by the Educational Institute of the American Hotel & Motel Association (AH&MA). Where appropriate, references are made to pronouncements of the Financial Accounting Standards Board (FASB) and the American Institute of Certified Public Accountants (AICPA).

Understanding Hospitality Accounting I is a comprehensive financial accounting text that integrates the specialized requirements of the hospitality industry with generally accepted accounting principles. It may be used by professionals as a reference source and by students as a learning tool.

This text uses an approach that concentrates on hospitality accounting principles, yet is authoritative in scope. Each topic is introduced with a basic presentation which gradually builds to more complex areas. The presentation is structured for easy learning and retention by the extensive use of definitions, concepts, illustrations, and pertinent discussion questions and problems.

Understanding Hospitality Accounting I builds a business vocabulary using a modular, step-by-step approach. It combines elements of financial and managerial accounting, emphasizing the mastery of accounting concepts in addition to actual problem solving.

Chapters 1, 2, 3, and 4 introduce the field of hospitality accounting and its relation to the hospitality industry as a whole, and the characteristics of financial information systems. In this manner, *Understanding Hospitality Accounting I* not only teaches the principles of accounting but also recognizes that accounting is part of the larger sphere of business activities. Topics such as starting a business, securing proper business insurance coverage, and safeguarding business assets by internal control are introduced to broaden the reader's awareness of the business environment.

Understanding Hospitality Accounting I gradually builds the essential foundation for understanding the overall accounting process. Chapters 5 and 6 detail the bookkeeping accounts which compose the five major accounting classifications, and the latter chapter addresses the two basic systems for inventory accounting. Chapter 7 analyzes the effects of business transactions, while Chapter 8 relates this analysis to the correct application of debits and credits.

Later chapters emphasize practical accounting procedures and the actual use of special journals in the hospitality industry. Chapters 9 and 10 concentrate on the recording of business transactions in the accounting records. Chapters 11 and 12 follow the accounting cycle through the monthly and end-of-year processes. These four chapters also employ a case study which begins with the recording of business transactions and continues through the completion of the accounting cycle.

As this text fulfills the special requirements of the hospitality industry and educators alike, I feel it fitting to offer my gratitude to industry personnel, fellow educators, and others who made its publication possible.

My colleagues who field-tested the text and course materials were especially helpful in providing comments and suggestions. Many thanks are due the students and hospitality accounting faculty of Johnson & Wales College.

I gratefully acknowledge two reviewers for their generous contributions of time and constructive comments: Ian Patrick Griggs, CPA, Partner/Director of Audit Operations, the Honolulu office of Touche Ross & Company; and Raymond S. Schmidgall, Ph.D., CPA, Hilton Hotels Professor of Hospitality Financial Management at Michigan State University.

Thanks are also extended to Jim M. Mulrooney, Vice President/Treasurer of Chi-Chi's, Inc., for furnishing his company's annual report, which serves as an illustration of actual financial statements.

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With honor and remembrance, I dedicate this book to my father and mother: Raymond E. Cote and Alice E. Cote.

Chapter Outline

- Why Study Accounting?
- The Function of Accounting
 - External Users
 - Internal Users
- Business Transactions
- Basic Accounting Activities
- The Accounting Profession
 - Branches of Accounting
 - Financial Accounting
 - Managerial Accounting
 - Cost Accounting
 - Tax Accounting
 - Auditing
 - Accounting Systems Design
- Professional Organizations
 - American Institute of Certified Public Accountants (AICPA)
 - Financial Accounting Standards Board (FASB)
 - International Association of Hospitality Accountants (IAHA)
 - American Hotel & Motel Association (AH&MA)
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- Use of Dollar Signs, Commas, and Zeros

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1 Accounting Theory and Practice

Accounting is often referred to as “the language of business.” Executives, investors, bankers, creditors, and governmental officials use this language in their day-to-day activities. In order to effectively communicate in today’s business world, a fundamental grasp of the theory and practice of accounting is required.

Many of those presently employed within the hospitality industry and many students new to the field of hospitality sometimes feel that the language of business is understood only by specialists who seem to thrive on “number crunching.” This misconception arises from an unfamiliarity with the fundamental purpose of accounting and the logic which lies behind basic accounting activities.

This introductory chapter will dispel many misconceptions about basic accounting activities while providing answers to such questions as:

1. Why should managers and supervisors understand the theory and practice of accounting?
2. What is the fundamental purpose of accounting?
3. How extensive a background in mathematics is needed to understand accounting activities?
4. What is the difference between bookkeeping and accounting?
5. What career opportunities are there in the field of accounting?
6. Are there fundamental principles of accounting that apply to every kind of business enterprise?

This chapter addresses the importance of understanding the theory and practice of accounting for managers, supervisors, and those students who are new to the field of hospitality. The major branches of the accounting profession are defined and organizations which serve the professional accountant are identified. Special attention is given to the generally accepted accounting principles which ensure that consistent accounting procedures are followed in the preparation of financial statements. The chapter closes with a brief discussion of the differences between generally accepted accounting principles and specific accounting procedures dictated by income tax law.

Why Study Accounting?

A knowledge of the basic theory and practice of accounting is a valuable tool with which to achieve success not only in the hospitality

industry but in the management of your personal finances as well. However, students planning careers in the hospitality industry often tend to neglect the accounting aspects of their field of study. Some believe that they will be able to “pick up” the essentials of accounting once they are out of school and on the job. But, once on the job, many find that day-to-day responsibilities confine them to specific areas of a property’s operation. Increased specialization within the hospitality industry at times creates a situation in which relatively few, outside of those actually employed within accounting departments, have opportunities to learn the theory and practice of accounting at a level required by the demands of today’s business world.

Most colleges require accounting as part of a business curriculum because the future managers of any type of business need to grasp the essentials of accounting in order to make sound business decisions. Managers need to understand how basic decisions regarding operational matters (such as replacing equipment or changing policy regarding the extension of credit to customers) will affect the financial statements of the business.

Managers and supervisors working in the hospitality industry realize the importance of understanding the basic theory and practice of accounting. In the highly competitive field of hospitality, successful careers often depend on an ability to make daily operating decisions based upon analyses of financial information. In order to achieve satisfactory profit objectives for their areas of responsibility, managers must thoroughly understand how the accounting system accumulates and processes financial information. The increasing use of computers to record accounting information and to prepare financial statements has not diminished the necessity of mastering this business language.

Some individuals are reluctant to learn the fundamentals of accounting because they mistakenly believe that accounting is “numbers oriented,” requiring a sophisticated background in mathematics. Accounting theory and practice is not based on complicated mathematics; it is based on *logic* and emphasizes basic terminology, fundamental concepts, and relatively straightforward procedures. Applying the logic of accounting requires only the most basic math skills: addition, subtraction, multiplication, and division. Once the terminology, concepts, and procedures of accounting are mastered, accounting practices are not as difficult to understand as some people tend to believe.

The Function of Accounting

The fundamental purpose of **accounting** is to provide useful and timely financial information. The American Institute of Certified Public Accountants offers a definition of accounting which emphasizes its functional nature.

Its function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.¹

Quantitative information may take the form of financial statements, forecasts, budgets, and many types of reports which can be used to evaluate the financial position and operating performance of a hospitality

business. Two major financial statements prepared by accounting departments are the balance sheet and the statement of income.

The balance sheet provides important information regarding *the financial position of the hospitality business on a given date*. This financial statement reports the assets, liabilities, and equity on a given date. Simply stated, assets represent anything a business owns which has commercial or exchange value, liabilities represent the claims of outsiders (such as creditors) to assets, and equity represents the claims of owners to assets.

The statement of income provides important information regarding *the results of operations for a stated period of time*. Because this statement reveals the bottom line (net income for a specified period), it is one of the most important financial statements used by managers to evaluate the success of operations.

Chapter 3 discusses basic financial statements in great detail. The balance sheet and the statement of income are mentioned here only to indicate that the financial information prepared by accounting departments is used by a number of different groups with various interests. These groups may be classified as either external or internal users of financial information.

External Users. These groups are those outside of the business who require accounting and financial information. Suppliers want financial information prior to extending credit to the hospitality operation. Bankers require financial statements prior to lending funds for building, remodeling, or major purchases. Investors and stockholders make decisions to buy, sell, or hold based on information in the financial statements. Various governmental agencies, such as the Internal Revenue Service, also require specific kinds of financial information.

Internal Users. These groups include those inside the hospitality business such as the board of directors, the general manager, departmental managers, and other staff involved in the day-to-day and long-range analysis, planning, and control of the hospitality operation. Hospitality managers require much more detailed information regarding day-to-day operations than is provided by the major financial statements. Exhibit 1.1 lists some of the reports generally prepared by an accounting department for various levels of management. The exhibit identifies the frequency, content, comparisons, recipient, and purpose of each report. In general, the more frequently managers must make decisions, the more frequent will be their need for specific kinds of financial and operational information.

Financial statements and accounting reports which are prepared for external and internal users are the end result of basic accounting activities. In order to fully understand financial statements and accounting reports, it is first necessary to understand how accounting activities transform “raw data” into useful and timely information. All accounting activities flow from events which are created by business transactions.

Business Transactions

Business transactions initiate the accounting process. A **business transaction** can be defined as the exchange of merchandise, property, or

Exhibit 1.1 Management Reports

Report	Frequency	Content	Comparisons	Who Gets It	Purpose
Daily Report of Operations	Daily, on a cumulative basis for the month, the year to date.	Occupancy, average rate, revenue by outlet, and pertinent statistics.	To operating plan for current period and to prior year results.	Top management and supervisors responsible for day to day operation.	Basis for evaluating the current health of the enterprise.
Weekly Forecasts	Weekly.	Volume in covers, occupancy.	Previous periods.	Top management and supervisory personnel.	Staffing and scheduling; promotion.
Summary Report — Flash	Monthly at end of month (prior to monthly financial statement).	Known elements of revenue and direct costs; estimated departmental indirect costs.	To operating plan; to prior year results.	Top management and supervisory personnel responsible for function reported.	Provides immediate information on financial results for rooms, food and beverages, and other.
Cash Flow Analysis	Monthly (and on a revolving 12-month basis).	Receipts and disbursements by time periods.	With cash flow plan for month and for year to date.	Top management.	Predicts availability of cash for operating needs. Provides information on interim financing requirements.
Labor Productivity Analysis	Daily Weekly Monthly	Dollar cost; manpower hours expended; hours as related to sales and services (covers, rooms occupied, etc.)	To committed hours in the operating plan (standards for amount of work to prior year statistics).	Top management and supervisory personnel.	Labor cost control through informed staffing and scheduling. Helps refine forecasting.
Departmental Analysis	Monthly (early in following month).	Details on main categories of income; same on expense.	To operating plan (month and year to date) and to prior year.	Top management and supervisors by function (e.g., rooms, each food and beverage outlet, laundry, telephone, other profit centers).	Knowing where business stands, and immediate corrective actions.
Room Rate Analysis	Daily, monthly, year to date.	Actual rates compared to rack rates by rate category or type of room.	To operating plan and to prior year results.	Top management and supervisors of sales and front office operations.	If goal is not being achieved, analysis of strengths and weaknesses is prompted.
Return on Investment	Actual computation, at least twice a year. Computation based on forecast, immediately prior to plan for year ahead.	Earnings as a percentage rate of return on average investment or equity committed.	To plan for operation and to prior periods.	Top management.	If goal is not being achieved, prompt assessment of strengths and weaknesses.
Long-Range Planning	Annually.	5-year projections of revenue and expenses. Operating plan expressed in financial terms.	Prior years.	Top management.	Involves staff in success or failure of enterprise. Injects more realism into plans for property and service modifications.
Exception Reporting	Concurrent with monthly reports and financial statements.	Summary listing of line item variances from predetermined norm.	With operating budgets.	Top management and supervisors responsible for function reported.	Immediate focusing on problem before more detailed statement analysis can be made.
Guest History Analysis	At least semi-annually; quarterly or monthly is recommended.	Historical records of corporate business, travel agencies, group bookings.	With previous reports.	Top management and sales.	Give direction to marketing efforts.
Future Bookings Report	Monthly.	Analysis of reservations and bookings.	With several prior years.	Top management, sales and marketing, department management.	Provides information on changing guest profile. Exposes strong and weak points of facility. Guides (1) sales planning and (2) expansion plans.

Source: *Lodging*, July 1979, pp. 40-41.

services for cash or a promise to pay. Specific accounts are set up to record the results of business transactions which involve promises to pay.

For example, if a restaurant buys merchandise or supplies on open account, this promise to pay is classified as an **Accounts Payable**. If a guest purchases food and beverage items from the restaurant on open account, the guest's promise to pay is classified as an **Accounts Receivable**. Promises to pay may also involve the use of legal documents. If, in order to purchase certain equipment, a restaurant obtains funds by signing a promissory note, the liability is classified as a *Notes Payable*. If realty (land or buildings) is involved, the liability is classified as a *Mortgage Payable*.

A business transaction creates events which affect two or more bookkeeping accounts in the accounting records. The following examples present very basic business transactions, describe the events created by those transactions, and identify the bookkeeping accounts which are affected by those events.

Example #1

When a guest enjoys a dinner at a restaurant and pays for the meal with cash, the business transaction that occurs is the exchange of food and services for cash. This business transaction creates the following events which affect the restaurant:

1. The cash received increases the assets of the restaurant.
2. A sale is made, thus increasing the sales volume (revenue).

These events affect the following bookkeeping accounts:

1. Cash
2. Food Sales

Example #2

When a guest enjoys a dinner at a restaurant and pays for the meal by charging the amount of the guest check to an open account maintained for him or her by the restaurant (no credit card is involved), the business transaction that occurs is similar to the previous example. However, in this case, food and services are exchanged not for cash, but for a promise to pay. The change in the method of payment does not affect the basic events created by the business transaction:

1. The guest's promise to pay increases the assets of the restaurant.
2. A sale is made, thus increasing the sales volume (revenue).

However, the change in the method of payment does change one of the accounts affected by the events. The promise to pay and the sale affect the following bookkeeping accounts:

1. Accounts Receivable
2. Food Sales

Example #3

When a restaurant buys food provisions on open account from a supplier, the business transaction which occurs is also an exchange of food and services for a promise to pay. However, the events created by this transaction which affect the restaurant are as follows: