

- Many expenses are a combination of payments and invoices or charges not yet paid (accounts payable).
- Depreciation and amortization are never a cash expense.

Assets, Liabilities, and Equity

The money illusion may affect balance sheet accounts as well. The accounts receivable shown on a balance sheet may not be 100 percent collectible. The allowance for doubtful accounts (potential bad debts) is an estimate. Also, the amount shown for land, buildings, and other assets may not represent the true cash value of these items.

Even the *Cash* account may not represent the potential cash position. Cash might be inflated because the payment of accounts payable and other liabilities has been deferred. Cash might be understated because short-term investments can always be sold to bolster the cash position. Another consideration is that the cash position of a company does not reflect its borrowing power.

The equity section of a balance sheet is composed of cumulative net income of the present and the past, which does not relate to cash. The stock issued amounts relate to the original issue date and amount; those funds have long been spent.



Key Terms

accumulated depreciation—The sum of all depreciation from prior years to the

equity—The owner's financial
financing activities—A section of the cash flow statement that reports the cash provided or cash used for the payment of dividends, and the payment of interest and principal on debt.
fiscal year—Business year. Can be different from the calendar year.
fixed charges—Expenses incurred that are not directly influenced by occupancy costs.
gross profit—The result of net sales minus the cost of goods sold.
interim financial statements—Financial statements prepared for periods shorter than a year.
investing activities—A section of the cash flow statement that reports cash provided or the cash used for the purchase and sale of property, plant, and equipment.
liabilities—The debts of a business.
long-term liability—Any debt that is due more than one year from the date. Also called *long-term debt*.
operating expenses—A section of the income statement that reports expenses that are most directly influenced by the company's operations.
operating activities—A section of the cash flow statement that reports the cash provided or the cash used for the company's primary revenue-generating activities.
revenue—The amounts billed to customers for goods and services.

Depreciation spreads the cost of an asset over the term of its useful life. Depreciation expense is the cost of depreciation for only the current accounting period; it is shown on the statement of income. Accumulated depreciation is the sum of all depreciation from prior years to the present and is shown on the balance sheet. It is important to stress that this procedure is not an attempt to establish the market values of assets. The cost of the asset minus the amount of its accumulated depreciation leaves the net asset value, or what is sometimes called the *book value*. This should not be confused with market value (the value that the asset could bring if sold on the open market).

Accumulated depreciation does not affect the noncurrent asset Land because land does not wear out *in the normal course of business*. Accumulated depreciation also does not affect China, Glassware, and Silver on the balance sheet because amounts for deterioration, breakage, and loss have already been deducted directly from this asset account.

Other Assets

The other assets portion of the balance sheet includes assets that do not apply to line items previously discussed. Security deposits include funds deposited with public utility companies (for instance, telephone, water, electric, and gas companies) and other funds used for similar types of deposits. Preopening expenses include capitalized expenses incurred before the opening of the property.

Current Liabilities

Current liabilities are obligations that will require settlement within twelve months of the balance sheet date. The total current liabilities figure alerts the restaurant operator to the operation's cash requirements and is often compared with the total figure for current assets.

Accounts Payable. This line item shows the total of unpaid invoices due to creditors from whom the restaurant receives merchandise or services in the ordinary course of business.

Sales Tax Payable. This line item includes all sales taxes collected from customers that are payable to federal or local government agencies.

Accrued Expenses. This line item lists the total amount of expenses incurred for the period up to the balance sheet date but that are not payable until after the balance sheet date and have not been shown elsewhere as a current liability.

Current Portion of Long-Term Debt. Since the total figure for current liabilities includes all obligations that will require an outlay of cash within twelve months of the balance sheet date, this line item includes the principal portion of long-term debt that is due within one year of the balance sheet date.

Long-Term Liabilities

A long-term liability (also called long-term debt) is any debt *not* due within twelve months of the balance sheet date. Any portion of long-term debt that is due within

twelve months of the balance sheet date is subtracted from the total outstanding obligation and is shown in the current liabilities portion of the balance sheet.

Equity Section

Exhibit 5 shows the equity section of the balance sheet prepared for a proprietorship. The Owner's Equity line item shows the interests of the sole owner in the assets of Deb's Steakhouse. The figure for Deb Barry's Capital account in Exhibit 5 is the same figure that appears as the current balance on the statement of owner's equity in Exhibit 3. If the balance sheet were prepared for a partnership, the interests of each partner would be shown as line items under Partners' Equity. Changes in equity accounts of the partners would be shown in a statement of partners' equity whose format would be similar to that of the statement of owner's equity.

Exhibit 6 shows the equity section of the balance sheet prepared for a corporate form of business organization. *Common Stock* shows the par value, the number of shares authorized, and the number of shares issued. *Additional Paid-In Capital* shows the total amount for cash, property, and other capital contributed by stockholders in excess of the par value of the common stock. *Retained Earnings* includes that portion of net income earned by the corporation that is not distributed as dividends, but is retained in the business. The figure for Retained Earnings in Exhibit 6 is the same as that shown at the bottom of the statement of retained earnings in Exhibit 4.

Statement of Cash Flows

The major purpose of the **statement of cash flows (SCF)** is to provide information about where a company's cash came from and where that cash was spent. Its focus is on **cash provided** or **cash used** and not on profit or loss. Cash flow is the net result of cash receipts minus cash payments. If cash receipts exceed cash payments, the cash flow is positive, also called a cash inflow, meaning cash has been *provided* by an activity. If the cash payments exceed the cash receipts, the cash flow is negative, also called a cash outflow, meaning cash has been *used* by an activity. The SCF is shown in Exhibit 7; note that it has three major sections:

- Operating Activities
- Investing Activities
- Financing Activities

The ending cash shown on the SCF must reconcile with the cash shown on the balance sheet. Note that the ending cash of \$34,000 on the SCF in Exhibit 7 is equal to the cash amount on the balance sheet in Exhibit 6.

Operating Activities

The **operating activities** section shows either the cash provided or cash used from the primary day-to-day operating activity of a business. For a restaurant, the primary day-to-day operating activity is cash generated from sales of food

Exhibit 5 Balance Sheet for a Proprietorship

**Deb's Steakhouse
Balance Sheet
December 31, 20X2**

ASSETS

CURRENT ASSETS

Cash		\$34,000
Accounts Receivable		4,000
Inventories		5,000
Prepaid Expenses		<u>2,000</u>
Total Current Assets		\$ 45,000

PROPERTY AND EQUIPMENT

	<u>Cost</u>	<u>Accumulated Depreciation</u>	
Land	\$ 30,000		
Building	60,000	\$15,000	
Furnishings and Equipment	52,000	25,000	
China, Glassware, Silver	<u>8,000</u>		
Total	150,000	<u>40,000</u>	110,000

OTHER ASSETS

Security Deposits		1,500
Preopening Expenses		<u>2,500</u>
Total Other Assets		4,000

TOTAL ASSETS

\$159,000

LIABILITIES

CURRENT LIABILITIES

Accounts Payable		
Sales Tax Payable		\$11,000
Accrued Expenses		1,000
Current Portion of Long-Term Debt		9,000
Total Current Liabilities		<u>6,000</u>
		\$ 27,000

LONG-TERM LIABILITIES

Mortgage Payable		
Less Current Portion of Long-Term Debt		40,000
Net Long-Term Liabilities		<u>6,000</u>
Total Liabilities		34,000
		61,000

OWNER'S EQUITY

Capital, Deb Barry—December 31, 20X2		
Total Liabilities and Owner's Equity		98,000
		<u>\$159,000</u>

Statement of Owner's Equity

The **statement of owner's equity** is prepared for a proprietorship form of business organization. The owner's capital account reflects the owner's residual claim on the assets of the business. The owner's claims are residual because they follow after claims to assets that creditors may have, as represented by the liabilities section of the balance sheet.

Exhibit 3 shows the statement of owner's equity for Deb's Steakhouse. Deb's equity for the period just ended is calculated by adding net income and subtracting withdrawals from the amount of owner's equity shown on the previous statement of owner's equity prepared for the prior period. (Normally, the owner's investments are also added; however, the proprietor in this example did not make such investments in her business during the current year.) The net income figure is the same figure that appears on the bottom line of the statement of income in Exhibit 1.

Statement of Retained Earnings

The **statement of retained earnings** is prepared for the corporate form of business organization. Its purpose is to compute the amount of earnings retained by the corporation. *Retained Earnings* represents the lifetime profits of the business that have not been declared as dividends to the shareholders.

Exhibit 4 illustrates the statement of retained earnings for Deb's Steakhouse Inc. Note that the amount of retained earnings for the period just ended is calculated by adding net income and subtracting dividends declared from the amount of retained earnings shown on the previous statement of retained earnings prepared for the prior period. The net income figure is the same as that appearing on the bottom line of the statement of income in Exhibit 2. *Dividends Declared* includes all dividends declared during the current accounting year regardless of whether they are paid or unpaid.

Balance Sheet

The **balance sheet** shows assets, liabilities, and equity, revealing the *financial position* of a business. This information is presented as of the close of business on a certain date. The expression used by accountants is that the balance sheet provides information *on a given date*. The phrase *on a given date* has an entirely different meaning from the phrase *for a stated period of time*, which is used to describe the time period covered by an income statement.

For example, a balance sheet dated March 31 would present the status of financial information as of the close of business on that particular day. If you were counting the cash you presently have, you would state a dollar amount as it exists on the date you performed the count. All amounts shown on the balance sheet represent a status of existence on a certain day.

The balance sheet is composed of three major sections:

- Assets
- Liabilities

Exhibit 7 Statement of Cash Flows

Deb's Steakhouse, Inc.
Statement of Cash Flows
December 31, 20X2

Cash Flows from Operating Activities:		
Cash provided from operations		\$ 27,000
Cash Flows from Investing Activities:		
Cash proceeds from sale of equipment	\$ 5,000	
Deposit on vehicles	(20,000)	
Cash used by investing activities		(15,000)
Cash Flows from Financing Activities:		
Issuance of 1,000 shares of common stock	11,000	
Payment of 20X1 dividends declared	(1,000)	
Cash provided from financing activities		10,000
Increase (decrease) in cash for the year		<u>\$ 22,000</u>
Cash at the beginning of the year		12,000
Cash at the end of the year		<u>\$ 34,000</u>

and beverages. For a hotel, the primary day-to-day operating activity is cash generated from rooms, dining room, gift shop, and other departments of the hotel. The generation of cash will be different from income because not all sales result in an immediate cash receipt and not all expenses require an immediate cash payment.

Investing Activities

The **investing activities** section shows the cash provided from the sale of or cash used for the purchase of:

- Short-term and other investments
- Land, buildings, and other property
- Equipment

For example, if a hotel purchased several vehicles with a \$20,000 cash deposit and a \$75,000 bank loan, the cash *used* is \$20,000; this amount would appear in the investing activities section of the statement of cash flows.

Financing Activities

The **financing activities** section shows the cash provided from activities such as issuance of capital stock or bonds and cash borrowings.

The financing activities section also shows cash used from activities such as payment of dividends and payment on the debt portion of cash borrowings.

Equity Statements

Equity statements reflect changes in equity that occurred during an accounting period. Exhibit 3 illustrates a statement of owner's equity prepared for a proprietorship; Exhibit 4 depicts a statement of retained earnings prepared for a corporation. The following sections explain the line items that appear on these equity statements.

Exhibit 3 Statement of Owner's Equity for a Proprietorship

Deb's Steakhouse
Statement of Owner's Equity
For the Year Ended December 31, 20X2

Deb Barry, Capital—January 1, 20X2	\$ 81,000
Add Owner's Investments during the year	0
Add Net Income for the year ended December 31, 20X2	37,000
Total	<u>118,000</u>
Less Withdrawals during the year	20,000
Deb Barry, Capital—December 31, 20X2	<u>\$ 98,000</u>

Notes:

1. The net income figure is from the Statement of Income illustrated in Exhibit 1.
2. The ending capital amount is transferred to the Balance Sheet illustrated in Exhibit 5.

Exhibit 4 Statement of Retained Earnings for a Corporation

Deb's Steakhouse, Inc.
Statement of Retained Earnings
For the Year Ended December 31, 20X2

Retained Earnings, January 1, 20X2	\$43,000
Add Net Income for the year ended December 31, 20X2	15,000
Total	<u>58,000</u>
Less Dividends Declared during the year	0
Retained Earnings, December 31, 20X2	<u>\$58,000</u>

Notes:

1. The net income figure is from the Statement of Income illustrated in Exhibit 2.
2. The ending retained earnings amount is transferred to the Balance Sheet illustrated in Exhibit 6.

Proprietorship IBIT	\$37,000
Corporation IBIT	<u>17,000</u>
Difference	\$20,000

This difference can be accounted for as follows:

Owner's salary	\$19,000
Owner's fringe benefits	<u>1,000</u>
Total	\$20,000

Fixed Charges

The **fixed charges** section of the statement of income includes rent, property taxes, property insurance, interest expense, and depreciation. Fixed charges are those expenses that are incurred regardless of whether the business is open or closed, and they remain relatively constant even with changes in sales volume.

Income Before Income Taxes

For a corporation, fixed charges are subtracted from income before fixed charges and income taxes to arrive at the amount of income before income taxes.

Note that the statement of income for a proprietorship (Exhibit 1) does not include this line item. Again, this is because a business organized as a proprietorship does not pay income taxes—the owner does.

Income Taxes

The income taxes section of the statement of income includes federal and other government income taxes. Again, note that this line item does not appear on the statement of income for a proprietorship.

Net Income (or Loss)

The bottom line of the statement of income reveals the net income (or loss) of the operation for a stated period. This figure will indicate the overall success of operations for the period of time covered by the statement of income. The amount of net income shown for the corporate form of Deb's Steakhouse differs from that of the proprietorship form of business organization because:

- The owner of a proprietorship cannot be paid a salary or wage; thus there are also no applicable payroll taxes on that salary or wage.
- The owner of a proprietorship is not entitled to deductible benefits.
- The owner of a proprietorship pays the income taxes of the business on his or her personal income tax return.

The net income difference of \$22,000 (\$37,000 – \$15,000) between the proprietorship and corporation is accounted for as follows:

Salary and fringe benefits attributable to proprietorship	\$20,000
Income taxes of the corporation	
Total	

Laundry and Dry Cleaning. This line item includes the cost of laundering table linens and uniforms; contracting for napkin, towel, and apron service; and cleaning uniforms, wall and window hangings, and floor coverings.

Credit Card Fees. This item includes the amount paid to credit card organizations for central billing and collection of credit card accounts.

Operating Supplies. This item represents supplies that have been used and are not includable as inventory. These include cleaning, paper, guest, and bar supplies. The statements of income for Deb's Steakhouse list Operating Supplies as a single line item. However, large operations may list the categories of operating supplies separately on the statement of income.

Advertising. *Marketing* is the more general term used to describe the varied expenses incurred in promoting a restaurant operation to the public. Items listed under marketing vary with the needs and requirements of individual properties. Deb's Steakhouse is a small operation, so its marketing expenses consistently include only advertising costs such as newspaper ads, circulars, and brochures. Therefore, it is more appropriate and informative for that operation to list Advertising instead of marketing as the operating expense item on the statement of income. Large restaurant operations, on the other hand, may incur significant marketing expenses in such areas as sales, advertising, and public relations. It would be appropriate for these properties to list the term *Marketing* as a direct expense line item on the statement of income.

Utilities. This line item includes the cost of electricity, fuel, water, ice and refrigeration supplies, waste removal, and engineer's supplies. Note, however, that the Utilities item does not include fuel used for cooking purposes. The cost of energy used for cooking purposes appears as a separate line item. If electricity or gas is used as kitchen fuel and for heating and lighting, it is necessary to use meter readings or to estimate usage to isolate kitchen fuel expense.

Repairs and Maintenance. This line item includes the cost of plastering, painting, decorating, repairing dining room furniture and kitchen equipment, plumbing, and heating repairs, and other maintenance and repair expenses.

Income Before Fixed Charges and Income Taxes

The figure for income before fixed charges and income taxes is used to measure the success of operations and the effectiveness and efficiency of management. Therefore, this section of the statement of income is extremely important to management. This figure is calculated by subtracting total operating expenses from the gross profit figure.

Note in Exhibit 1 that, for a proprietorship form of business organization, this section of the statement of income reads as "Income Before Fixed Charges." Income taxes are not mentioned because a proprietorship does not pay income taxes—the owner does. A proprietorship's business income is reported on the owner's personal income tax return.

The difference between the proprietorship and corporation income before income taxes (IBIT) is as follows:

Operating Expenses

The **operating expenses** section of the statement of income lists expenses that are most directly influenced by operating policy and management efficiency. If the statement of income showed these expenses as a single line item, this would not communicate much information to the users of the statement. Breaking out each of the significant operating expenses allows managers and others to readily identify expense areas that may be excessive and that call for further analysis and possible corrective action. A brief explanation of the line items included under operating expenses on the statements of income for Deb's Steakhouse follows.

Salaries and Wages. This line item includes the regular salaries and wages, overtime pay, vacation pay, and any commission or bonus payments to employees. Note that the figure shown as salaries and wages for the corporation form of Deb's Steakhouse is greater than the salaries and wages figure shown for the proprietorship form of Deb's Steakhouse. This difference results from the fact that the owner of a proprietorship cannot be paid a salary or wage.

Specifically, the difference can be accounted for in the following salaries and wages analysis:

Corporation	\$55,000
Proprietorship	36,000
Attributable to owner	<u>\$19,000</u>

Employee Benefits. This line item includes the cost of free employee meals, Social Security and Medicare taxes (FICA), federal and state unemployment taxes, union and nonunion insurance premiums, state health insurance, union and nonunion pension fund contributions, medical expenses, workers' compensation insurance, and other similar expenses. Expenses related to employee benefits can be significant for restaurant operations. Note that the amount for employee benefits shown for Deb's Steakhouse, Inc., is greater than that shown for Deb's Steakhouse (proprietorship). This difference arises because: (a) an owner of a proprietorship cannot deduct benefits on his or her behalf, and (b) there are no payroll taxes on behalf of the owner, since wages cannot be paid to an owner.

Specifically, the difference can be accounted for in the following employee benefits analysis:

Corporation	\$7,900
Proprietorship	6,900
Attributable to owner	<u>\$1,000</u>

China, Glassware, and Silverware. These items are generally considered direct service expenses rather than repair and maintenance expenses. Therefore, replacement costs for china, glassware, and silverware appear here as a separate item under Operating Expenses. This line item also includes the depreciation expense for china, glassware, and silverware.

Kitchen Fuel. This line item includes only the cost of fuel used for cooking, such as gas, coal, charcoal briquettes, steam, electricity,

Exhibit 1 Statement of Income for a Proprietorship

Deb's Steakhouse
Statement of Income
For the Year Ended December 31, 20X2

REVENUE		
Food Sales	\$120,000	
Liquor Sales	<u>50,000</u>	
Total Revenue		\$170,000
COST OF SALES		
Food	42,000	
Liquor	<u>11,000</u>	
Total Cost of Sales		<u>53,000</u>
GROSS PROFIT		117,000
OPERATING EXPENSES		
Salaries and Wages	36,000	
Employee Benefits	6,900	
China, Glassware, and Silverware	300	
Kitchen Fuel	900	
Laundry and Dry Cleaning	2,100	
Credit Card Fees	1,500	
Operating Supplies	5,000	
Advertising	2,000	
Utilities	3,800	
Repairs and Maintenance	<u>1,900</u>	
Total Operating Expenses		<u>60,400</u>
INCOME BEFORE FIXED CHARGES		56,600
FIXED CHARGES		
Rent	6,000	
Property Taxes	1,500	
Insurance	3,600	
Interest Expense	3,000	
Depreciation and Amortization	<u>5,500</u>	
Total Fixed Charges		<u>19,600</u>
NET INCOME		<u>\$ 37,000</u>

Note: The net income figure is transferred to the Statement of Owner's Equity illustrated in Exhibit 3

- Revenue
- Cost of Sales
- Gross Profit
- Operating Expenses
- Income Before Fixed Charges and Income Taxes
- Fixed Charges
- Income Before Income Taxes
- Income Taxes
- Net Income (or Loss)

The following sections discuss these categories in some detail and provide a brief explanation of the line items appearing within them. Exhibits 1 and 2 point out the differences between statements of income prepared for proprietorships and those prepared for corporations.

Revenue

Revenue results when products and services are sold to guests. The total revenue figure on the statement of income indicates the actual dollar amount that guests have been billed for products and services offered by the hospitality property.

Revenue is *not* income. Revenue appears at the top of the statement of income; net income (or loss) appears at the bottom. Income results when total revenue exceeds total expenses. A loss results when total expenses exceed total revenue.

Exhibits 1 and 2 show the total revenue figure for Deb's Steakhouse at \$170,000. Note that revenue generated by food sales (\$120,000) is listed separately from revenue generated by beverage sales (\$50,000). Distinguishing the major sources of revenue allows management to identify the separate contributions of the food operation and the beverage operation to the establishment's total gross profit.

Cost of Sales

The **cost of sales** section of the statement of income shows the cost of merchandise used in the selling process; it does not contain any cost for labor or employee meals. Since the revenue appearing on the income statement for Deb's Steakhouse resulted from sales of food and beverages to guests, the cost of sales figure (\$53,000) represents *the cost of food and beverage merchandise served to guests*. Cost of sales can also be called *cost of goods sold*.

Gross Profit

Gross profit is calculated by subtracting cost of sales from net revenue (net sales). Gross profit is sometimes referred to as *gross margin* or *gross margin on sales*.

Gross profit is an intermediate income amount from which operating expenses and fixed charges are deducted to arrive at net income. Gross profit must be large enough to cover all of these expenses for the business to earn a net income.

4. What is the purpose and content of the statement of retained earnings?
5. What is the purpose and content of the balance sheet?
6. What is the purpose and content of the statement of cash flows?

Basic Financial Statements

The basic financial statements prepared by hospitality businesses are the statement of income, the equity statement (the name of which varies by business form), the balance sheet, and the statement of cash flows. These four statements present independent information, yet have a relationship to each other. For example, the income (or loss) from the income statement is transferred to the equity statement; the result of the equity statement is carried over to the balance sheet; the statement of cash flows is prepared from information on the income statement and the balance sheet.

Annual financial statements are issued at the end of a company's business year, also called a fiscal year. A **fiscal year** might be a calendar year or a year consisting of twelve consecutive months starting in any month other than January. It is customary for companies whose stock is publicly traded to issue an elegant packet containing the financial statements, a president's letter to stockholders, and glossy pictures of products, people, and services. Managers, stockholders, investors, creditors, and other interested parties are eager to obtain the annual statements of businesses so that they can properly examine and evaluate the companies' performances.

The Internet site of any company whose stock is publicly traded should provide a link to the company's annual financial statements, as well as links to other corporate information.

The best-run companies also issue monthly financial statements to management. Those companies whose stock is publicly traded also issue quarterly financial statements to their stockholders. Such statements issued during the business year are called **interim financial statements**.

Statement of Income

The **statement of income** shows revenue and expenses and provides information about the *results of operations* for a stated period of time. This is the financial statement that shows whether a business operated at a profit or loss for the period of time covered by the statement. The time period may be one month or longer, but does not exceed one business year. Since the owners of proprietorships or partnerships pay personal income taxes on the net income from their operations, their fiscal years generally begin on the first of January. However, the fiscal year of certain corporate forms of business organization may be any twelve consecutive months.

Since the statement of income reveals the results of operations for a period of time, it is an important measure of management's effectiveness and efficiency. Understanding how the statement is used to evaluate management is the key to understanding the logic behind the sequence of categories that appears on the statement. The major categories that appear on the statement of income are: