1

Introduction to Numbers, Accounting, and Financial Analysis

Learning Objectives

1. To understand the three most common measurements of a company's success.
2. To recognize how important understanding accounting and finance is to the career of any hospitality manager.
3. To learn about and describe the three fundamental financial statements.
4. To become familiar with fundamental revenue accounting concepts.
5. To understand fundamental profit accounting concepts.
6. To learn the revenue and profit formulas.

Chapter Outline

Numbers: The Lifeblood of Business

- Accounting Concept
- Customers, Associates, and Profitability

Career Success Model

- Technical Skills
- Management/Leadership Skills
- Financial Skills
- Marketing Skills
- High-Performance Organizations

The Three Main Financial Statements

- Profit and Loss Statement
- Balance Sheet
- Statement of Cash Flows

Accounting concepts and methods of financial analysis generally sound intimidating and complicated. Visions of CPAs, financial advisors, tax laws, attorneys, big ugly books, spreadsheets, paperwork nightmares, and migraine headaches regularly accompany any mention of accounting and finance. And this is often the case. However, entry-level hospitality managers need to be able to use accounting concepts and methods of financial analysis to conduct the daily operations of their departments. They need to understand them and be able to effectively apply them to their department operations.

Numbers are also used to measure a company's performance in meeting expected strategies, goals, and objectives. Typically, there are three commonly used measurements of success:

Customer satisfaction
Employee satisfaction
Profitability and cash flow

Performance is measured and defined against these goals with the use of numbers.

This chapter introduces fundamental accounting concepts and explains how numbers are used to apply these accounting concepts to daily operations. It likewise introduces fundamental methods of financial analysis and explains how numbers are used to perform financial analysis. The objective is, first, to understand these fundamental concepts; second, to be comfortable working with them; and, third, to be able to apply them. Subsequent chapters will go into more detail and build on the foundation developed in this chapter.

Numbers: The Lifeblood of Business

Numbers—understanding them and working with them—form the foundation of both accounting concepts and methods of financial analysis. Numbers provide descriptions and measurements that relate to the operations of a business. Let's define a few terms.

Accounting Concept

Accounting refers to the bookkeeping methods involved in making a financial record of business transactions and in the preparation of statements concerning the assets, liabilities, and operating results of a business. A concept is a general understanding, especially one derived from a particular instance or occurrence. These definitions are from Webster's dictionary and not from an accounting book. We combine the two definitions and the resulting definition of accounting concepts is *a general understanding of the bookkeeping methods and financial transactions of a business*.

Financial Analysis: Finance is the management of monetary affairs. Analysis is the separation of an intellectual or substantial whole into its parts for individual study. These definitions are also from Webster's dictionary. We combine the two definitions, and our definition of financial analysis is *the separation of the management of monetary affairs of a business into parts for individual study*.

Fundamental arithmetic is all that is required to use and apply numbers to understand business operations. Two of the most important formulas in financial analysis only require multiplication and subtraction:

$$\textit{Revenue} = \textit{Rate} \times \textit{Volume}$$
$$\textit{Profit} = \textit{Revenues} - \textit{Expenses}$$

Although these two formulas can be applied to many market segments, departments, and volume levels and can become rather detailed, the fact remains they are each calculated with arithmetic and not calculus, trigonometry, or college algebra.

There is a common theme in today's business world about how to measure the success of a company or business. It involves satisfied customers, satisfied employees, and satisfactory profitability. As an example, we can look at one of the largest and most successful companies in the world to examine these concepts.

By two important measurements—market capitalization and recognition—General Electric (GE) is a company we can learn from. In 2003, GE was the largest company in the world in terms of **market capitalization**. The formula for market capitalization is the stock price times the number of shares of stock outstanding. To be the largest capitalized company in the world means that more individuals and institutions are investing in GE than in any other company, which is quite an accomplishment. GE was also the Most Admired Company in the United States from 1997 to 2001 and in 2005 was #2 on the Most Admired Company List according to *Fortune* magazine. Former CEO Jack Welch, in discussing the GE management philosophy in *Jack Welch and the GE Way* by Robert Slater (1999), is quoted as saying:

> We always say that if you had three measurements to live by, they'd be employee satisfaction, customer satisfaction and cash flow. If you've got cash in the till at the end, the rest is all going to work, because if you've got high customer satisfaction, you're going to get a share. If you've got high employee satisfaction you're going to get productivity. And if you've got cash, you know it's all working. (p. 90)

This statement highlights the relationship or balance between three essential ingredients of a successful business: customers, employees, and profitability. These three measurements are interrelated, and problems with one will lead to problems with the others. Numbers are involved in measuring the success of each of these measurements.

Customers, Employees, and Profitability

Customer satisfaction can be measured by percentage of market share, percentage of revenue growth, or the successful introduction of new products and services. All of these measurements use numbers. For example, market share can increase from 7% to 8%. This tells us that customers are buying more of our products, and our sales have now increased from 7% to 8% of the total market. If a company's market share is growing, it means that customers choose to buy its products over those of the competitors because of quality, value, or both. That is obviously a good thing. If our market share is declining, that means customers are not buying as many of our products and services, and that is a bad thing. Numbers tell us to what degree our business is improving or declining.

Another way to measure customer satisfaction is with customer satisfaction surveys. This process provides direct customer feedback based on questions asked in a survey. A typical question is "Are you willing to return?" The hotel will have a historical score that shows the performance for the previous year and will set a new goal for the next year of operations. Each time the current score is reported—generally monthly—it is compared with the actual score from the previous year to see if the hotel is improving. It is also compared to the goal for the current year to see if the goal will be missed, met, or exceeded.

Employee satisfaction is measured in the same way. Each hotel will have its score from the previous year for the questions asked, as well as a goal for the year. The current score on the survey is compared to these benchmark scores, and then evaluations are made if there has been progress toward reaching the goal. For example, the most recent employee satisfaction score of 85% favorable would be compared to last year's 83% and this year's goal of 84%. The 85% current score is a 2-point improvement over last year and is 1 point above this year's goal. In this example, the actual score of 85% beat both last year's actual and this year's goal. Numbers define the relationship between the scores and determine if performance is declining, staying the same, or improving.

Profit or profitability is the third measure. Is a company making or losing money? **The equation for profitability is revenues minus expenses**. For example, $1,000,000 in revenues minus $750,000 in expenses would result in a $250,000 profit. In addition to being expressed in dollars, profit can also be expressed in terms of percentages. **The equation for profit percentage is profit dollars divided by revenue dollars**. In our example, the profit percentage is 25% ($250,000 profit divided by $1,000,000 in revenues).

Each of these numbers or measures tells us something about the operations of the business. The $250,000 in profit dollars tells us that we have that much money in the bank after recording all the revenues and paying all the expenses. It is a tangible amount. In other words, there is a $250,000 balance in the cash account of the business. The 25% profit percentage tells us the amount of every revenue dollar that is left over as profit. It is a relationship measure. In other words, 25 cents out of every sales dollar represents profits, and 75 cents out of every sales dollar represents expenses. Add the two and you get $1, or 100%.

The best-selling book, *Built to Last, Successful Habits of Visionary Companies* by James E. Collins and Jerry I. Porras (1994), talks about the role of profits in some of the most well-respected companies in the world. Consider this comment:

> Profitability is a necessary condition for existence and a means to more important ends, but it is not the end in itself for many of the visionary companies. Profit is like oxygen, food, water and blood for the body; they are not the point of life, but without them, there is no life. (p. 55)

The authors point out that the visionary companies focus on other elements of their business that reflect their core values, not profits. This focus can be on new product development, risk taking customers, employees, or stretch goals. Because they do this so well, products and services are well received in the marketplace, and sufficient profits result.

These discussions of customer satisfaction, employee satisfaction, and profitability illustrate the role that numbers play in measuring or defining results and achievements. Numbers assign a tangible value to performance and results. Instead of simply saying that revenues are up, numbers enable us to say, for example, revenues are up $100,000 or 8.5%.

This is more specific and helps a business identify and compare its performance from month to month or year to year. These concepts will be discussed in more detail in later chapters.

Career Success Model

Certain skills and abilities are required for any manager to have a successful business career. Stephen R. Covey talks about three of these in his book *The Seven Habits of Highly Effective People* (1989). Covey defines skill as "how to do," knowledge as "what to do," and attitude as "want to do" (p. 47). The use of these three abilities determines how successful a manager can be.

The Career Success Model Figure 1.1 identifies four individual skills and one organizational skill that are helpful in enabling managers to grow and advance with a company. It is important that managers continue to grow and learn, and this includes new areas that will broaden their knowledge and skills.

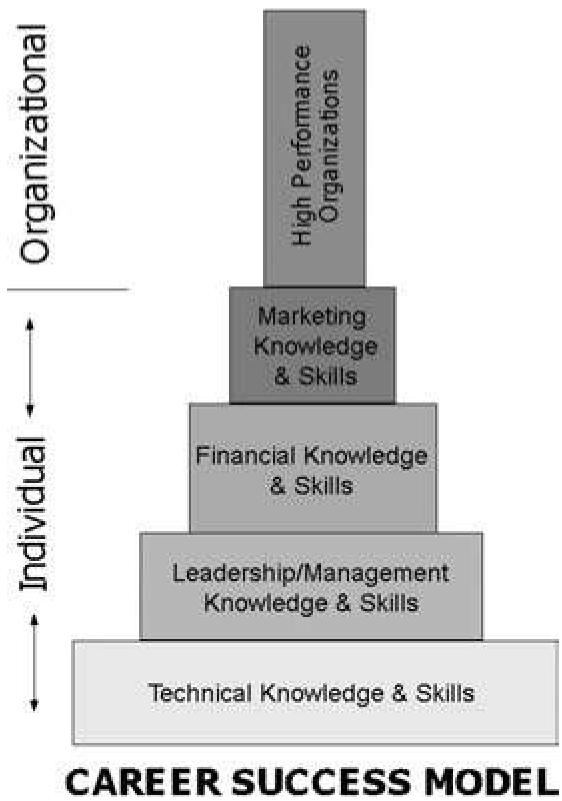

FIGURE 1.1 Career Success Model.

Technical Skills

These are the day-to-day operational knowledge and skills required to get the job done. Entry-level managers in the hospitality industry start out, for example, as Assistant Desk Managers, Assistant Housekeeping Managers, Assistant Restaurant Managers, and so forth. The job title defines what they are expected to know and be able to do to perform all the tasks and responsibilities for operating their department. So they spend the first year learning and doing. That should be their focus—to learn all the technical and operational aspects of their job. This includes knowing and being able to perform the job responsibilities of all the employees that report to them. Assistant Desk Managers will be checking guests in and out, managing room inventories, handling group business, staffing the concierge level, running fronts for the bellman, and so on. Assistant Restaurant Managers will be seating customers, busing tables, and expediting food orders. Understanding these technical aspects of a department's operations is essential to its success and to establishing a solid foundation for personal career growth.

Management/Leadership Skills

The first promotion provides a manager with the opportunity to manage others in getting the job done. The knowledge and skills needed include working with other managers as well as hourly employees. This step involves the progression from managing (we manage things) to leading (we lead people) (Covey). A manager is now paid to get other people to do the job. This includes the typical management responsibilities of planning, organizing, and control, but has now progressed to the leadership responsibilities of motivating, challenging, engaging, supporting, and recognizing employees. The real definition of a leader is the ability to teach and inspire the people he or she works with to do the best job that they are capable of doing.

Leaders also have the responsibility to allocate company resources. This includes allocating time, money, labor, and ideas to the most productive or profitable areas. They do this by listening to employees and customers, then prioritizing projects or job responsibilities, and then supporting them with sufficient resources.

Effective leaders take the time to organize their work and make sure that they are spending as much of their time as possible operating in Covey's Quadrant 2—important but not urgent. Most managers operate in Quadrant 1—important and urgent—which can best be defined as putting out fires and going from one situation to another. By shifting to Quadrant 2, a manager has more time to plan, prioritize, and organize the work to be done. Quadrant 2 is proactive; Quadrant 1 is reactive (Covey, p. 151).

What does this have to do with accounting and finance? Everything! Specifically, the more knowledgeable and comfortable managers are working with numbers and completing the accounting and financial analysis part of their job, the more time they will have to spend with their customers and employees—their top priorities!

Unfortunately, the careers of many managers slow down or stop at this point. They do not have the interest, knowledge, or ability to learn the next skills that will help them to do a better and more complete job, and advance to taking on more and wider levels of responsibility. It is not enough to have technical skills and management/leadership skills when attempting to advance to higher positions within a company. These positions require the knowledge and the ability to understand and use accounting concepts and marketing concepts in the daily operations of the company.

Financial Skills

Financial knowledge and skills begin with understanding numbers, having the ability to communicate or teach what the numbers mean, and finally having the ability to apply what is learned from numbers to improve the operations of the business. Specifically, it is the ability to interpret and discuss the information contained in all types of financial reports with all levels of management. A manager must be comfortable talking about the financial aspects of his or her department with the hotel's Director of Finance and the General Manager. Explaining revenues and expenses, comparing actual results to budgets and forecasts, and making adjustments to improve operations are all important financial skills for any manager to possess.

The rest of this textbook is devoted to developing an understanding of accounting concepts and methods of financial analysis. At this point it is important to understand that any manager must have a fundamental understanding of accounting and finance to grow and advance with a company. Managers do not have to be Certified Public Accountants or Directors of Finance. But they must be able to understand and intelligently discuss their department operations and financial performance with senior management.

Marketing Skills

The next step in the Career Success Model is developing sales and marketing knowledge and skills, which begins by understanding customers and their expectations. What does a hotel or restaurant do to develop and maintain a competitive advantage over its competitors? Why does a customer choose to stay in a particular hotel or eat in a particular restaurant? The marketing department is responsible for identifying customer preferences, expectations, buying patterns, and behavior patterns. These customer descriptions are then classified into different market segments. A hotel or restaurant chooses the market segments where it wants to and can successfully compete.

Examples of major hotel market segments are Transient, Group, and Contract. The transient market segment includes concierge customers at the higher end of room rates, then progressively lower market rate segments of regular, corporate, special corporate, and finally discounts. The discount market segment can further be separated into government and military, American Association of Retired People (AARP), the travel industry, and special promotions like weekend or super saver rates. Examples of the major restaurant market segments are fine dining, casual dining, and fast food.

Each of these market segments is defined by specific customer expectations and behavior patterns. For a manager to continue to advance, she or he must understand the marketing of the hotel or restaurant. What are the strengths and competitive advantages of a property? What are the expectations and preferences of customers? A manager must be able to discuss customers with the Director of Sales or Marketing and understand the marketing plan and positioning of the hotel or restaurant.

High-Performance Organizations

When a manager is knowledgeable and comfortable with these four individual skills—technical, management and leadership, financial, and marketing—then he or she has the potential to be a part of a high-performance organization. A manager with strong individual skills and knowledge and with a positive and proactive attitude can then create or be a part of an organization that not only meets but exceeds the expectations and goals it has established. This should be an important career goal.

The ultimate goal of any department within a hotel or restaurant is to achieve outstanding performance and results. This requires a team effort by all involved in the operation. The greater the degree of knowledge and skill in these four areas, the greater the contribution a manager can make to the performance of his or her team or department. Only when a manager can translate excellence of individual performance into excellence of team performance can the manager truly excel and achieve excellence.

The Career Success Model outlines the knowledge, skills, and abilities that are required to be successful in business and to advance to senior management positions. The goal of this textbook is to provide students with the accounting and financial knowledge, skills, and abilities necessary to be successful in the careers that they choose.

The Three Main Financial Statements

It is important for any business manager to be aware of and understand the financial statements that are used in evaluating the performance of a business. These financial statements are applied in many different ways in describing and evaluating the operations and financial strength of a business. Each of these financial statements or reports measures a specific aspect of the operation of a business. They are introduced here and explained in more detail in a future chapter.

Profit and Loss Statement

The **Profit and Loss (P&L) Statement** measures the operating success and profitability of a business. It is also known as the Income Statement. This is the main financial report that describes and measures the profitability of the daily operations of a business. Key characteristics of the P&L Statement are as follows:

1. It covers a specific time period, for example, monthly, quarterly, or annually.
2. It reports the actual financial results for a business for the specific time period.
3. It compares the actual performance to other measures such as budget, the previous year, previous months, or previous periods.
4. It includes a summary or consolidated P&L statement and supporting department P&L Statements.
   a. Consolidated P&L Statements summarize revenues and expenses by departments.
   b. Department P&L Statements report in detail revenues, expenses, and profits for specific departments.
5. A new P&L Statement is started each month or period and records information for the current month and year-to-date (YTD).
6. Managers are expected to analyze or critique their monthly P&L Statements to explain variations from the budget or from the previous year, both positive and negative.

The P&L Statement is the most important financial report for a manager to understand and work with on a daily basis. This is because managers work with and can affect revenues or they can control most of the costs and expenses. Their daily activities in operating the business produce the numbers reported on the P&L. Consequently, a manager who knows and understands the P&L will provide accurate and timely information that is used in preparing the P&L Statement and that gives it credibility. It will be an accurate report that measures the financial profitability of a business. A manager who does not understand the P&L Statement might omit important information, provide the wrong information, or miss deadlines that prevent information that should be reported from being included in the proper time frame.

This textbook spends most of its content on explaining the P&L Statement and discussing how it is used as a management tool to measure financial performance. It is also important to understand how the information on the P&L Statement relates to the other key financial statements or reports. Exhibit 1.1 is an example of a Consolidated P&L.

EXHIBIT 1.1

CONSOLIDATED P&L STATEMENT

The ABC Company
December 31, 2003

	Current Period			Year to Date		
	Actual	Budget	Last Year	Actual	Budget	Last Year
Rooms Sales						
Restaurant Sales						
Catering Sales						
Total Sales						
Rooms Profit						
Restaurant Profit						
Catering Profit						
Total Department Profits						
General and Administrative (G&A) Expense						
Repairs and Maintenance (R&M) Expense						
Utilities						
Sales and Marketing						
Total Expense Center Costs						
House Profit or Gross Operating Profit						
Fixed Expenses						
Net House Profit or Adjusted Gross Operating Profit						

Balance Sheet

The **Balance Sheet** measures the value or worth of a business. It is also known as the Asset and Liability (A&L) Statement. This is the main financial report that measures what a company is worth. Key characteristics of the Balance Sheet are as follows:

1. It measures the value or worth of a company at a specific point in time. For example, the Balance Sheet for December 31, 2003, is a snapshot of accounts at that specific point in time and identifies what a company owns (assets), what it owes (liabilities), and how it is owned (owner equity).
2. The fundamental account equation describes the A&L:

Assets = Liabilities + Owner Equity

3. It is made up of accounts organized by asset, liability, or owner equity.
4. These accounts are divided into current accounts (under one-year obligations), also referred to as working capital, and long-term accounts (over one-year obligations), which are referred to as capitalization.
5. Each account has a beginning balance, monthly activity, and an ending balance.
6. Unlike the P&L Statement, managers are not expected to provide critiques of monthly balance sheet activity. This is done by the accounting department.
7. Accounting managers balance monthly the accounts of a balance sheet.

It is important for managers to understand the Balance Sheet because (1) they use the current asset and liability accounts (**working capital**) in the daily operations of their business, and (2) it shows how the company is **capitalized**—with long-term debt, paid-in capital, or both. They are expected to efficiently use the assets of a business to operate it profitability. Exhibit 1.2 is an example of a Balance Sheet.

EXHIBIT 1.2

BALANCE SHEET

The ABC Company
December 31, 2003

Assets	*Liabilities*
Cash	Accounts Payable
Accounts Receivable	Taxes Payable
	Accrued Liabilities
Inventory	Total Current Liabilities
Prepaid Expenses	
Total Current Assets	Bank Loan
Property	Equipment Loan
Plant	Total Long-Term Liabilities
Equipment	
Total Long-Term Assets	TOTAL LIABILITIES
TOTAL ASSETS	*Owner Equity*
	Paid-In Capital
	Common Stock
	Retained Earnings
	TOTAL OWNER EQUITY

Statement of Cash Flows

The **Statement of Cash Flows** measures the liquidity and the flow of cash of a business. Specifically, it is the activity of the cash account of a business. Sales are recorded as cash inflows through point of sale systems (cash registers) and expenses are recorded as cash outflows through accounts payable or electronic transfers. It is important for a manager to know how much cash is available in the company's cash account to pay expenses and to plan for future operating obligations. If a business does not have sufficient cash in its cash bank account, it will not be able to pay expenses. It is an important responsibility of any manager to understand the business's working capital accounts and to be able to use them efficiently and effectively.

The increases and decreases in account balances of balance sheet accounts also affect cash flow. Referred to as the Source and Use of Funds Statement, this report describes how cash flows in and out of the different accounts in the Balance Sheet. This also reflects the cash strength or liquidity of a business. Liquidity is the ability of a business to pay its short-term obligations and the amount it has in current assets, specifically cash and cash equivalents.

It is important for every manager to understand that a business can be profitable from month to month and still go out of business. This is because these businesses are not effectively managing their cash. They simply do not have enough money in their cash account to pay expenses; therefore, they go out of business even though they show profits on their P&L Statement and have a fairly good balance sheet. If you cannot pay your expenses, you cannot stay in business. Therefore, understanding the basics of managing cash flow is critical to the success of both managers and a business.

Key characteristics of the Statement of Cash Flows are as follows:

1. It involves the cash account of the Balance Sheet.
2. It has beginning and ending balances.
3. It shows how money is used in the daily operations of the business.
4. It measures liquidity.
5. It is a fundamental component of working capital.
6. It reflects the increases and decreases in Balance Sheet accounts.

There are three classifications of cash flow activities:

1. Operating activities of the daily operations of a business that produce sales.
2. Financing activities that involve raising and spending cash. This is also referred to as capitalization.
3. Investing activities that involve investing cash in other financial options.

See Exhibit 1.3.

EXHIBIT 1.3

STATEMENT OF CASH FLOWS

ABC Company
December 31, 2003

Net Income from Operations

Plus Sources of Funds
  Decreases in Assets
  Increases in Liabilities
  Increases in Owner Equity
Minus Uses of Funds
  Increases in Assets
  Decreases in Liabilities
  Decreases in Owner Equity
Total Sources and Uses of Funds from Operations
Total Sources and Uses of Funds from Investments
Total Sources and Uses of Funds from Financing

TOTAL SOURCES AND USES OF FUNDS

Photo: JW Marriott Desert Ridge Resort & Spa

JW Marriott Desert Ridge Resort & Spa

This is a view of the resort's pool complex and Wildfire golf course. This 950-room convention/resort hotel includes 200,000 square feet of meeting space, 10 restaurants and lounge outlets, a 28,000-square foot spa, and two 18-hole golf courses. The resort includes 22 departments, 1,200 employees, and 104 managers. There are nine members of the executive committee/leadership team. Consider the complexity of managing this resort with the additional amenities and services that it provides. Financial reports are important to the successful operation of this convention hotel/resort.

The Revive Spa at Desert Ridge is one of the many profit centers of this resort. It includes 41 treatment rooms, group workout rooms, and a food and beverage outlet occupying 28,000 square feet. It is one of the largest resort spas in the United States.

Revenues: The Beginning of Financial Performance

One of the fundamental business concepts is that a company is in business to make money. The company produces products or services and exchanges them with customers for an agreed-upon price. The assumption is that the business will be in operation for many years, continually offering not only the existing products and services but new ones as well. This process generates **revenues** or sales and involves the following actions:

- The company receives money from customers for products or services.
- Money or method of payment can include cash, credit cards, debit cards, electronic transfers, personal checks, traveler's checks, or company checks.
- The sales transaction is recorded through a **point-of-sale (POS)** system previously referred to as cash registers and now referred to as computer terminals and systems. This completes the sales transaction.
- The method of payment is balanced to the amount of product purchased or type of service experienced.

Revenues are the first step of financial analysis because they start the cash flow process of a company. Revenues result in cash increasing or flowing into the company's cash account. The next step is paying all expenses associated with producing the product or service the company offers. Paying expenses result in cash decreasing or flowing out of a cash bank account through accounts payable, payroll disbursements, or other disbursements. Any remaining amount is referred to as profit.

Revenues are also recorded on the period, monthly, quarterly, or annual P&L Statements. The P&L is the financial report that lists revenues, expenses, and profits in a logical and orderly format. Chapter 4 discusses the P&L Statement in more detail.

In the chapter introduction, we discussed two important formulas. We will now add a third important formula. Each involves revenue. The first formula calculates revenue and the formula is **Rate × Volume = Revenue**. The second formula calculates profit and the formula is **Revenue – Expenses = Profit**. The third formula measures revenue performance and is called **REVPAR**. REVPAR can be calculated two ways. The formulas are

Total Room Revenues / Total Available Rooms or **Average Rate × Occupancy Percentage**. Let's learn more about these important formulas.

Formulas

Rate × Volume = Revenue

All revenues for a business are the result of the number of customers buying a product or service. This is combined with how much they pay for that product or service to calculate revenues or sales. For example:

Room Revenues	Rooms Sold × Room Rates
Restaurant Revenues	Customers Served × Menu Prices
Golf Revenues	Player Rounds × Greens Fees
Spa Revenues	Treatments × Treatment Prices
Gift Shop	Merchandise Sold × Price

Volume is defined as the number of units sold, served, received, or bought by customers during a specific time frame. Rooms sold are generally recorded daily. Restaurant customers are generally recorded by meal period: breakfast, lunch, and dinner. Each one of these transactions has a price or rate associated with it. This is called a rate structure, price list, or menu. For example, rooms sold might be divided into the transient market segment and the group market segment. Each would have a room rate associated with it: Transient rate = $99; Group rate = $85. Golf would have a daily price list per player: Greens fees = $50 with cart, $36 without cart; Twilight special rate = $25. Restaurants have menus listing the items available and their price. Customers in a restaurant choose what they want to eat and how much they are willing to pay for it.

To calculate any of the three revenue variables, we just need to know two variables and apply the appropriate formula. The following is an example for calculating room revenue:

Rate × Volume = Room Revenue or $99 × 150 Rooms Sold = $14,850 Room Revenue
Room Revenue / Volume = Rate or $14,850 Room Revenue / 150 Rooms Sold = $99 Average Rate
Revenue / Rate = Volume or $14,850 Room Revenue / $99 = 150 Rooms Sold

Following is an example for restaurant revenue:

Rate × Volume = Restaurant Revenue or $8 Average Check × 75 Customers = $600 Restaurant Revenue
Restaurant Revenue / Volume = Rate or $600 / 75 = $8 Average Check
Restaurant Revenue / Rate = Volume or $600 / $8 = 75 Customers

The POS system records all of this information and produces two types of financial reports. First, it reports financial performance in daily revenue reports. Second, it provides management with reports that are used as management tools to operate the business. A hospitality manager will be expected to understand these reports and use them to analyze rates, price lists, or menu prices along with the number of customers served. These managers are expected to understand their daily operations, to identify how successful or profitable they are, and to determine how to solve problems and improve operations.

When analyzing revenues, it is important to identify where increases or decreases are coming from and what caused any changes. Are there increases in the number of guests or increases in the amount they are spending/paying? In identifying causes, any of the following might apply:

Did lower rates or prices produce higher volumes?

Did an advertising campaign produce higher volumes?

Did new competition lower volumes?

Did a rate increase result in lower volumes?

Revenue – Expense = Profit

All profits for a department, restaurant, or hotel can be calculated with this formula. Although this formula appears quite basic, it is broken down into many different categories that reflect different market segments for sales and specific types of costs or expenses. For example, the Rooms Department profit is calculated by adding Transient, Group, and Contract revenues to identify total room revenue. Then all direct expenses are deducted from total revenue to calculate total room profit. The formula is as follows:

Total Room Revenue minus	$500,000
Wage Expense	$60,000
Benefit Expense	$21,000
Other Operating Expenses	$44,000
Equals Total Room Profit	$375,000

REVPAR: Revenue per Available Room

The most important measurement used to evaluate room revenues is REVPAR, or revenue per available room. The reason it is so important is because it considers both rate and volume in identifying the amount of revenues generated by a hotel. It is only used to evaluate room revenue and is expressed as a dollar rate. For example, suppose REVPAR is $88.43. Two formulas can be used to calculate REVPAR. The first formula is the most accurate, but the second formula will also be very close and it is acceptable to use either one.

Total Room Revenue / Total Rooms Available
or
Average Rate × Occupancy Percentage

Let's calculate our REVPAR using the information from our previous revenue example. Room revenue was $14,850 with an average rate of $99 and 150 rooms occupied. We need to include the total number of rooms in our hotel to calculate the occupancy percentage. If we have a 200-room hotel, we can calculate our occupancy percentage by dividing rooms sold by total rooms or 150/200 = 75% occupancy. Now we can calculate our REVPAR:

$99 Average Rate × 75% Occupancy = $74.25 REVPAR
or
$14,850 Room Revenue/200 Total Rooms = $74.25 REVPAR

REVPAR is one of the first and most important measurements used to evaluate financial performance for hotels because it is an indication of how well management is able to increase the average rate and also achieve higher volume and occupancy to maximize revenue. If only one of these measurements is used, it will not be able to determine if a hotel is maximizing room revenues.

For example, if we use occupancy as the main measurement of maximizing room revenue, running a hotel with 99% occupancy but with a $25 average rate is not maximizing room revenue. The hotel is probably selling its rooms too cheap. Likewise, if a hotel has a $175 average rate but is only running a 15% occupancy, it also is not maximizing room revenue. It is probably pricing its rooms too high. If we use occupancy as the most important measure, the hotel in our first example is doing an excellent job and our second hotel is doing a terrible job. If we use average rate as the most important measure, the hotel in our first example is doing a terrible job and our second hotel is doing an excellent job. *REVPAR combines rate and occupancy to more effectively measure management's performance in maximizing revenue!* It shows how well management is able to achieve a high occupancy percentage as well as attain a high average room rate and effectively use both to maximize total room revenues.

Market Segments

REVPAR tells us how the total hotel is doing to maximize total room revenue. To provide more specific information on room revenue maximization, the hotel separates its customers into market segments. Market segments define the customer in terms of expectations, preferences, buying patterns, behavior patterns, and why the customer is traveling. Each market segment has distinctive characteristics. Three of the main market segments used in hotel operations are illustrated next.

Weekday/weekend. Most weekday travel is for business and most weekend travel is for pleasure.

Business/pleasure. People traveling on business generally have their expenses paid for by their employer. People traveling for pleasure are generally with family or friends and pay their own expenses.

Transient, group, and contract. These three primary room market segments identify who is traveling and why the person is traveling.

Transient

The transient segment refers to individual business or pleasure travelers. They can be further segmented by the room rate they are willing to pay. Following is an example of a room rate structure that defines specific market segments and ranges from highest to lowest room rates:

Concierge	$149 room rate
Regular or rack rate	129
Corporate	119
Special corporate	75–110, depending on the number of rooms
Discount	
AARP	95
Government	85
Travel industry	75
Weekend super saver	69

Group

Groups are travelers that include two or more people who stay more than one night. They generally get a discounted rate because they provide greater volume. A hotel will specify what qualifies as a group rate—for example, three or more rooms for one night or two or more rooms for two nights or more. The larger the number of rooms in the group, the lower the room rate. Groups can be business or pleasure travelers and generally involve additional catering and meeting room rental revenue. Market segment examples include the following:

Corporate group	Sports and government
Association group	Other group

Contract

The contract market segment includes a fixed number of rooms sold per night at a fixed room rate for a specific company. The company is charged for this number of rooms each night whether they are occupied or not. The best example of contract rooms is airline crew rooms. American or Delta would contract with a hotel for 25 rooms per night at a room rate of $40. This is for weekday and weekend rooms, year round. Hotels agree to a substantially lower room rate because this company will provide a base amount of business each day of the year. Unless a hotel is selling out with 100% occupancy, a $40 contract room sold is a lot better than an empty room and will generate some incremental revenue.

The Customer

A final thought on revenues. The actual event of checking a customer in or out of a hotel, serving a meal in a restaurant, providing a treatment at a spa, or assigning a tee time at the golf course involves employees talking with the guests and providing them with the product or service they are requesting. How this transaction takes place is extremely important to the success of a business. “Next!” “Checking in?” “Name?” These are hardly gracious or friendly greetings. A friendly greeting, eye contact, personal customer recognition, and a smile all go a long way in making customers feel good about the amount they are paying and the service they are receiving. Although it is important to accurately record the transaction with the customer for the accounting records, it is equally important to do so in a friendly and efficient manner. The POS system will generally take care of all the financial information, leaving the employee more time to talk with the customer and maximize his or her experience. The end result is that the customer wants to come back!

This goes back to our three measurements of a successful business: satisfied customers, satisfied employees, and sufficient cash flow or profitability. Although this textbook focuses on accounting and financial transactions and reports, it is always important to remember that employees and guests are the ones who make the whole cycle work.

Profit: The Ultimate Measure of Financial Performance

Just as revenues provide the starting point for measuring financial performance, profits provide the end result of all the effort and activities in operating a business. This section discusses the different aspects of profits. We will review once again the formula for profits: **Revenue minus expenses equals profits**.

Calculating profits is a simple formula, but it gets more detailed as you apply it to the different departments involved in operating a large business such as a hotel. Profits are what are left over after recording all revenues and then paying all expenses associated with generating those revenues. Just as there are different types of revenues, there are different types of expenses and different levels of profits. We will discuss several of the important profits next.

Department Profit

Department operations are the foundation to operating any business. Each department separates the business into different and distinct operations, and the revenues and expenses involved in operating those departments are shown on the Department P&L Statement. These departments are called revenue centers or profits centers. The largest profit departments in a hotel are rooms, restaurants, beverages, and banquets. The basic profit formula—revenue minus expenses—can be applied, but with more detail:

Rooms Department
- Transient, Group, and Contract Revenues
- Less Expenses
  - Wages
  - Benefits
  - Other Operating Expenses
- Equals Rooms Department Profit

Restaurant Department
- Breakfast, Lunch, and Dinner Revenues
- Less Expenses
  - Cost of Sales
  - Wages
  - Benefits
  - Other Operating Expenses
- Equals Restaurant Department Profit

All the department profits are added up to total hotel profit.

House Profit (Marriott) or Gross Operating Profit (Hyatt and Four Seasons)

These two profit terms are interchangeable and reflect basically the same profit measurements. Whereas Marriott identifies these profits as House Profit, Hyatt and Four Seasons prefer to call them Gross Operating Profit. They are the next level of profitability after Total Department Profits.

After Total Department Profits have been calculated, other indirect expenses are involved in operating a hotel that also must be paid as part of the daily operations. These departments are called expense centers or overhead because they generate no revenues but incur expenses in support of those departments that do generate revenues. Examples of expense centers are general and administrative (G&A), repairs and maintenance (R&M), utilities or heat, light, and power (HLP), and sales and marketing (S&M). These departments have total department expenses instead of total department revenues.

An example of these department statements follows:

Expenses
  Wages
  Benefits
  Other operating expenses
Total department expense

All of the expenses centers are added up, and this Total Expense Center cost is subtracted from Total Department Profits to produce the House Profit or Gross Operating Profit. Our equation for House Profit or Gross Operating Profit becomes

House Profit or Gross Operating Profit =
Total Department Profit – Total Expense Center Costs
or
Total Department Profit – Deductions from Income

House Profit or Gross Operating Profit is used primarily as a measurement of management's ability to maximize revenues, control expenses, and maximize profits. The hotel management team is organized to have influence and control over all the revenues and expenses recognized at the house profit level. Therefore, it is the profit level used to calculate management bonuses.

Net House Profit or Adjusted Gross Operating Profit

There are still expenses associated with operating a hotel that have not been recognized and recorded at the House Profit level. These expenses are generally referred to as fixed expenses, overhead expenses, or investment factors. What distinguishes these types of expenses is that they are fixed and generally have no relationship to the business levels of the hotel. The hotel could be closed or running a low or a high occupancy level, and, regardless, these expenses will involve the same amount and will have to be paid. Because management has no control of or say over these expenses, they are not included in bonus calculations. Examples of these fixed expenses are bank loans, mortgage payments, insurance costs, licenses, permits and fees, and depreciation.

The equation for Net House Profit or Adjusted Gross Operating Profit is as follows:

House Profit or Gross Operating Profit – Fixed Expenses

Net House Profit or Adjusted Gross Operating Profit is a true or accurate measure of the overall profitability of the hotel. It is the amount of profit or money that goes to the bank. All direct and indirect costs and fixed or variable costs have been recognized and paid.

Think of this profit as the profits that are available to be split among the owner, the management company, the franchisee, or any other entity that has an operating stake in the hotel.

Profit before and after Taxes

The final expenses to be recognized and paid are any taxes associated with operating the hotel. It is important to determine who will pay these taxes. It could be the owner or the management company depending on the management contract. This will have an impact on Net House Profit or Adjusted Gross Operating Profit depending on how the payment of taxes is defined. Generally, Profit before Taxes is the same as Net House Profit or Adjusted Gross Operating Profit. After all applicable taxes are paid, the true bottom line profit or Profit after Taxes is determined. We will not spend much time discussing profit before taxes, as a hospitality manager has little involvement with this profit level.

Summary

The use of accounting concepts and methods of financial analysis all begin with using numbers to measure financial performance. Numbers are a language that provides specific and detailed information that explains and measures company operations. Numbers evaluate operational performance, determine value, measure liquidity, and provide management with a detailed tool to manage the business.

Hospitality managers need to develop business financial literacy, which is the ability to understand numbers and to be comfortable working with numbers and using them to analyze business operations. Numbers are a means to an end; in other words, they help to measure and evaluate business operations. It is equally important for career advancement that a hospitality manager is able to understand and use numbers in business operations *and* is able to discuss and explain the operations in financial terms with senior management, including the General Manager and the Director of Finance for the hotel.

Three financial statements are used in evaluating a company or business. The first and most important is the P&L Statement (also called the Income Statement), which measures financial performance. Second is the A&L Statement (also called the Balance Sheet), which measures the net worth of a company or business. Third is the Statement of Cash Flow, which measures the liquidity and cash balances of a company or business.

Three important formulas for hospitality managers to know and use are revenue, profit, and REVPAR. They also need to understand the main profit levels of a hotel: Total Department Profits, House Profit or Gross Operating Profit, and Net House Profit or Adjusted Gross Operating Profit.

Hospitality Manager Takeaways

1. **Hospitality accounting is about using numbers and fundamental arithmetic in evaluating and improving operating performance. It is all about fundamentals!**
2. **The Profit and Loss (P&L) Statement is the most important financial statement that a hospitality manager needs to completely understand and be able to use in operating his or her departments.**
3. **Understanding and using numbers (accounting and finance) effectively are essential to the career advancement of every hospitality manager.**
4. **Numbers contained in financial statements are used to measure financial performance and to provide managers with a valuable management tool.**
5. **Accounting and financial management is all about maximizing revenues, minimizing expenses, maximizing profits, and using numbers to measure and improve financial performance.**

Key Terms

Accounting Concepts—The bookkeeping methods and financial transactions used in daily business operations.

Balance Sheet—Measures the value or net worth of a business.

Capitalization—The source and methods of raising money to invest in and start a business.

Financial Analysis—The separation of a business's management of monetary affairs into parts for individual study.

Liquidity—The amount of cash or cash equivalents that a business has to cover its daily operating expenses.

Market Capitalization—A measure of the value of a company that includes the number of shares outstanding held by individual and institutional investors times the current stock price of the company.

Market Segment—Customer groups defined by expectations, preferences, buying patterns, and behavior patterns.

Point-of-Sale (POS) System—The equipment that records the customer transaction, including identifying the method of payment and reporting the type of transaction.

Profit—The amount of revenues left over after all appropriate expenses have been paid.

Profit and Loss (P&L) Statement—Measures the operating success and profitability of a business.

Property—The term for the physical hotel or restaurant.

Revenue—The monetary amount that customers pay to purchase a product or service.

It can be in the form of cash, checks, credit cards, accounts securable, or electronic transfer.

Revenue per Available Room (REVPAR)—An important measure of a hotel's ability to generate room revenue by measuring average rate and occupancy percentage.

Statement of Cash Flows—Measures the liquidity and flow of cash of a business.

Working Capital—The amount of money utilized in the daily operations of a business.

It includes using current assets and current liabilities as well as cash in producing a product or service.

Formulas

Average Rate	Room Revenue / Rooms Sold
Market Capitalization	Number Shares Outstanding × Stock Price
Occupancy Percentage	Rooms Sold / Total Rooms
Revenue	Rate × Volume
Profit Dollars	Revenue – Expenses
Profit Percentage	Profit $ / Revenue $
REVPAR	Total Room Revenue / Total Available Rooms or Average Rate × Occupancy Percentage
Working Capital	Current Assets – Current Liabilities

Review Questions

1. Name and describe the three main financial statements of a business.
2. List the important characteristics for each of these statements, including the important accounts in each.
3. Define REVPAR and explain why it is so important as a revenue measurement for room revenues as well as total hotel financial performance.
4. Name and describe three profit levels in a hotel.
5. What is the difference between capitalization and working capital? What is each used for in business operations?
6. Why is understanding accounting concepts and methods of financial analysis important to a hospitality manager?
7. What are three key measurements of the performance of a business?
8. Why is the P&L Statement the most important for a hospitality manager to understand?