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The Balance Sheet (A&L) and Statement of Cash Flow

Learning Objectives

1. To become familiar with other financial statements that are used to measure financial performance.
2. To understand the use of the Balance Sheet (also called the A&L) by hospitality managers and accounting managers.
3. To understand how the Balance Sheet is used with the P&L in managing operations.
4. To understand the difference between capitalization and working capital.
5. To understand the Statement of Cash Flow and its uses.
6. To understand the importance of liquidity and profitability.

Chapter Outline

Summary

Hospitality Manager Takeaways

Key Terms

Review Questions

There are three financial statements that have the greatest value in measuring the operations and financial performance of a business: the Profit and Loss (P&L) Statement, the Balance Sheet (or Asset and Liability [A&L] Statement), and the Statement of Cash Flow. We discussed the P&L in Chapter 4. In this chapter we will discuss the Balance Sheet and the Statement of Cash Flow.

Whereas the P&L is mainly used by hotel managers as a management tool and a measure of financial performance, the Balance Sheet and Statement of Cash Flow are also used by owners, bankers, and other outside institutions or agencies that have a financial interest in the business. They want to understand the financial strength and stability of a business that will permit that business to operate successfully and profitably over time. The P&L measures financial performance. *The balance sheet and statement of cash flow measure the ability of a business to sustain and produce profitable operations.* What resources does the business have, how effectively do they use them, and how sufficient are they in maintaining ongoing profitable operations?

This chapter discusses in detail the Balance Sheet and Statement of Cash Flow and how they are used primarily to measure financial performance but also as a management tool. Hospitality mangers should have a fundamental understanding of these two financial statements to go along with a strong and detailed knowledge of the P&L. This knowledge enables managers to discuss the financial aspects of their operations with senior management and to demonstrate the financial knowledge and skills presented in the career success model discussed in Chapter 1.

The Balance Sheet or Asset and Liability (A&L) Statement

The purpose of the **Balance Sheet** is to measure the financial status, value, and net worth of a business. It is also referred to as the A&L. It is prepared at the end of each month or accounting period as well as at the end of the year. The Director of Finance or the corporate accounting office is responsible for preparing the Balance Sheet each month and ensuring that the accounts are accurate and in balance.

Definition

The Balance Sheet measures the status or net worth of a business as of a specific date. It is like a snapshot in time. The Balance Sheet shows the amounts or balances in each account as of a specific date. It is called the Asset and Liability Statement because it shows the balances in each of the assets and liability accounts. It is called the Balance Sheet because, again, that is what it shows—the *balance* in each of the accounts at a specific time. Exhibit 5.1 on page 94 is an example of the Balance Sheet for the Flagstaff Hotel.

The Balance Sheet measures the value or worth of a business. 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, a Balance Sheet might be prepared at the end of the year, December 31. It is a snapshot of account balances at that specific point in time that identifies what a company owns (assets), what it owes (liabilities), and how it is owned (owner equity).
2. The **Fundamental Account Equation** describes the Balance Sheet. This equation is

   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 (less than one-year obligations), also referred to as working capital, and long-term accounts (longer than 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.
8. Current accounts are used as working capital in operating the business. The definition of working capital is current assets minus current liabilities.
9. Long-term liability accounts and owner equity accounts are used as capitalization, which provides the money to start, renovate, or expand a business.

It is important for managers to understand the Balance Sheet because they use the current assets and current liability accounts (working capital) in the daily operations of their business. They are expected to efficiently use the assets of a business to operate it profitably. Following are definitions that describe important balance sheet accounts:

- **Current Assets—**Less than one-year life.
- **Cash—**Money that is in the cash bank account and available to use in daily business operations. It can be in a savings or checking account. It is the most liquid form of an asset. It is available immediately.
- **Accounts Receivable—**Dollar amounts that the company is owed for providing products and services to customers but that is uncollected. These accounts go through a direct billing process and are expected to be paid generally within 30

days. Credit cards and direct billing to companies are the two major parts of accounts receivable. It is the next most liquid asset after cash.

- **Inventories—**Supplies or materials that the company has purchased but not used in order to provide products and services to its customers. Examples of important inventories for hospitality operations are food, beverage, china, glass, silver, linen, cleaning supplies, and guest supplies. The company has purchased and paid for the inventory but has not put it to use. Inventory is not considered very liquid because it must first be converted into a final product, then sold, and then the proceeds collected and deposited into the cash account.
- **Prepaid Expenses—**Obligations of a hotel paid in advance and charged to department P&L accounts on a predetermined schedule such as monthly for six months or monthly for one year.
- **Long-Term Assets—**Longer than one-year life.
- **Property—**Land that is purchased to provide the building to produce products and services. This is the land on which a hotel or restaurant is located.
- **Plant—**The physical structure or building that houses the business operation. This is the actual hotel or restaurant building.
- **Equipment—**The machines and other assets that are used to produce the product or service. This is the kitchen equipment, guest room furniture and fixtures, restaurant tables and chairs, vehicles, washers and dryers, heat-light-power equipment, computer systems, and all other machines used in a hotel or restaurant.
- **Depreciation—**The portion of the total cost of property, plant, and equipment that is charged each year to the actual operations of a business. It is calculated by dividing the total cost by the number of years of useful production life to get the annual cost or depreciation charged to a specific year.
- **Current Liabilities—**Less than one-year obligations.
- **Accounts Payable—**Products or services received but not paid for that are due within one year. The invoices have been received, approved, and are in the process of payment.
- **Wages Payable—**Wages owed but not paid to employees who have performed the expected labor responsibilities. The employees have worked, but the paychecks have not been distributed or cashed.
- **Taxes Payable—**Taxes that have been collected but not paid to the appropriate tax agency. Taxes are typically paid quarterly or annually.
- **Advance Deposits—**Funds received from customers before the arrival date to guarantee sleeping rooms, meeting space, and other products or services. This can be a major current liability for resorts and convention hotels.

- **Accrued Liabilities—**Amounts owed for purchases received but not paid for at the end of month or end of period cut-off date.
- **Long-Term Liabilities—**Longer than one-year obligations.
- **Bank Loans—**Amounts owed to banks or other financial institutions that will be repaid over an extended number of years, generally from 5 to 30 years. Bank loans are used for capitalization including startup, renovation, or expansion.
- **Line of Credit—**A form of bank loan where a specific dollar amount is set aside for the business to use. The business may draw on or use these funds as needed. When used, they are repaid on similar terms as a bank loan.
- **Lease Obligations—**The land, building, or equipment that is leased, not purchased, and is recognized as a long-term liability according to the contract.
- **Owner Equity—**Investment in a company in the form of paid-in capital, common or preferred stock, and retained earnings.
- **Paid-in Capital—**The amount invested to start a company by the owners of a company or business. It is the dollar amount that they provide from their own financial resources.
- **Common Stock—**The amount invested by other individuals or institutions by purchasing common or preferred stock in the company or business. The value of this investment is determined by the price of the company stock as it is traded on the open market.
- **Retained Earning—**The portion of annual operating profits that the company keeps. It improves the strength of the Balance Sheet and the company as it grows each year.

The format of the Balance Sheet comes from the Fundamental Accounting Equation. The Fundamental Accounting Equation states that the dollar amount or value of assets must equal the dollar amounts or value of the liabilities and owner equity used to purchase the assets. In other words, what you *own* should equal what you *owe* to financial institutions in the form of loans or to owners in the form of investment.

Assets = Liabilities + Owner Equity

- An **asset** is a resource. In business, it is all the property of a business that can be applied to covering liabilities (Webster's dictionary).
- A **liability** is a debt. In business, it is something owed to another, a legal obligation (Webster's).
- **Owner equity** is possession and value and is defined in two parts. To *own* is to have or possess, and *equity* is the value of property beyond a liability (Webster's).

The Fundamental Accounting Equation shows these relationships and defines them with dollar balances and values. The Asset total amount must equal the Liability and Owner Equity amount. This ensures that all funds and transactions are accounted for according to accounting rules and principles. The rules and procedures that govern accounting in business are called generally accepted accounting principles, or GAAP. A business needs to collect, prepare, and report their accounting results according to these principles in order to be recognized as valid and accurate. Anyone who reads financial statements prepared in accordance with GAAP can have confidence in the accuracy and validity of the numbers contained in those statements. Exhibit 5.1 is an example of a Balance Sheet.

EXHIBIT 5.1

BALANCE SHEET

Flagstaff Hotel
June 30, 2004

ASSETS		**LIABILITIES**	
Current		**Current**	
Cash	$ 75	Accounts Payable	$ 60
Accounts Receivable	40	Wages Payable	40
Inventories	90	Taxes Payable	25
Total Current Assets	$205	Total Current Liabilities	$125
Long Term		**Long Term**	
Property	$125	Bank Loans	$150
Plant	200	Line of Credit	50
Equipment	150	Lease Obligations	25
Less Depreciation	50	Other Long-Term Obligations	0
Total Long-Term Assets	$525	Total Long-Term Liabilities	$225
Total Assets	**$730**	**Total Liabilities**	**$350**
		OWNER EQUITY	
		Paid-in Capital	$200
		Capital Stock	100
		Retained Earnings	380
		Total Owner Equity	**$380**
Total Assets	**$730**	**Total Liabilities and Owner Equity**	**$730**

We will now apply the financial information in Exhibit 5.1 to the characteristics of the Balance Sheet as an example.

1. Assets = Liabilities + Owner Equity
   or
   $730 Total Assets = $350 Total Liabilities + $380 Owner Equity or $730

   The Fundamental Accounting Equation is in balance because the $730 in total assets is equal to the $730 in total liabilities and owner equity.

2. Ending balances as of June 30, 2004, are as follows:

Current Assets	$205	Current Liabilities	$125
Long-Term Assets	$525	Long-Term Liabilities	$225
Total Assets	$730	Total Liabilities	$350
		Paid-in Capital	$200
		Capital Stock	$100
		Retained Earnings	$ 80
		Total Owner Equity	$380

   These are the ending balances in the major accounts as of June 30, 2004. Anyone reading the Balance Sheet will rely on these numbers as being accurate as to the value or net worth of the Flagstaff Hotel as of this date.

3. Current Accounts / Long-Term Accounts

Current Accounts		Long-Term Accounts	
Current Assets	$205	Long-Term Assets	$525
Current Liabilities	$125	Long-Term Liabilities	$225
		Owner Equity	$380

   The values or account balances in the current and the long-term balance sheet accounts are as shown as of a specific date—June 30, 2004.

4. Working Capital = Current Assets – Current Liabilities
   $80 Working Capital = $205 Current Assets – $125 Current Liabilities

   The Flagstaff Hotel working capital is $80. This tells us that the Flagstaff Hotel has $80 left as working capital reflected by the $205 already committed and invested in current assets and the $125 currently owed in current liabilities. The $80 is the remaining amount available for use in operating the business.

5. Capitalization = Liabilities + Owner Equity
   or
   $730 Capitalization = $350 Liabilities + $380 Owner Equity

This tells us that the Flagstaff Hotel has total assets of $730 and that the company was financed by $350 in debt or long-term liabilities and $380 in equity.

Working Capital

Working capital is the dollar amount provided for the daily operations of a business. It is invested in the current assets of a business, primarily in cash, accounts receivable, and inventory. The initial dollar amount invested as working capital is deposited in the cash account. Then it is invested in inventories as part of the process of providing products and services to customers (Figure 5.1). When a sale is made and the customer has not yet paid for the product or service, that dollar amount is identified as accounts receivable. When the credit card company sends electronic transfers as payment, or when individuals or companies send checks as payment, they are deposited directly into the cash account.

Working capital also involves the use of the current liabilities of a business, primarily in accounts payable, wages payable, and taxes payable. When the company receives materials and supplies that are used in providing products and services but has not yet paid for them, they are recognized as accounts payable. As the invoices documenting amounts received and prices charged are approved by department heads for payment, the accounts payable clerk processes a check and sends it out as payment. When the checks are mailed, the corresponding accounts payable is closed out and no longer recognized as a current liability. The same is true for wages owed employees and taxes owed government agencies. Wages owed employees are accrued until the paychecks are distributed and cashed. Taxes are collected during a specified time period—quarterly or annually—and then paid. Until they are paid, they are recognized as accounts payable.

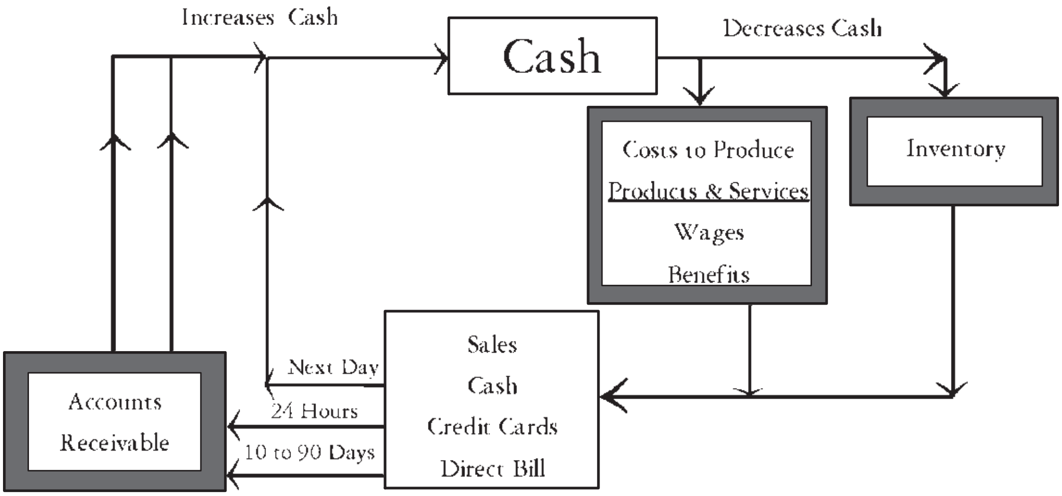

FIGURE 5.1 Business Operating Cycle.

The definition of working capital is current assets minus current liabilities. Another term closely associated with working capital is *liquidity*. Liquidity is the ability of a business to meet its short-term financial obligations. The larger the cash balances of a business, generally, the more liquid the company is or the more capable it is of paying its financial obligations. A company cannot afford to invest too much in inventory or let accounts receivable get too large. If that happens, it means that the company is taking longer to return cash to the cash account after it has been used to purchase materials and supplies or that the company is taking too long to collect accounts receivable and convert these balances into cash. That means that a company will have dollars tied up in large inventory and accounts receivable accounts rather than in the cash account where they can be used to operate the business.

Capitalization

Capitalization identifies the way a business obtains and uses money to start or expand the business. Capital is money or property that is used to create more money or property. Capitalization involves the use of long-term debt or owner equity (capital) as a way of obtaining the necessary funds or money to start a business. Technically, capital refers to the funds contributed to a company by the owners or stockholders. Capital also describes the net worth of a company (Webster's). We include long-term debt as well as owner equity in our definition of capitalization because long-term debt is another source of obtaining the necessary money or financing to start a business.

Referring to our example in Exhibit 5.1 and point 5, the capitalization of the Flagstaff Hotel is $730 and was obtained with $350 in long-term liabilities and $380 in owner equity.

Capitalization can be in the form of three activities. First is the initial startup costs of establishing a company, which involve purchasing mainly long-term assets. Second is capital replacement of older long-term assets as they wear out or become inefficient or obsolete with new long-term assets. Third is capital expansion, which is the use of capital to expand and grow the business. Capitalization provides the financial resources to invest in a business for the long term. These financial resources *should not* be used as working capital in the short term for the daily operations of a business. If a company has to use long-term capital to pay daily operating expenses, it is not generating sufficient revenues from its daily operations to cover operating expenses. This is a major liquidity problem that could result in a company not being able to pay its bills and eventually going out of business.

Photo: Miami Airport Marriott Hotel

Courtyard Miami Airport South and Miami Airport Marriott Hotel

This 778-room 6-building hotel underwent a major conversion in 1995 that significantly changed the way it operated. It went from operating as a large 778-room full-service Marriott hotel to operating three different Marriott brands. It now operates three buildings as a 281 room Fairfield Inn by Marriott, one building as a 125-room Courtyard by Marriott, and two buildings as a 366-room full-service Marriott. The picture shows the Courtyard in the foreground and the original of the two 9-story full-service Marriott towers in the background. The Fairfield Inn is located on the right but not included in the picture.

As a result of this conversion from one to three different brands, revenues increased over 30%. What do you think the impact was of this revenue increase on cash flow for the property? Do you think the increase was in room rate or rooms sold? The owners invested a significant amount to convert this property from one brand to three brands. How did this conversion affect the Balance Sheet for this property? Is this conversion an example of capitalization or working capital? Do you think the owners received a good ROI (return on investment)? How would you calculate the ROI?

Working Relationships between the Balance Sheet and the P&L Statement

Managers' Use of Balance Sheet Accounts in Daily Operations

Hospitality managers work primarily with the P&L statement. It measures the financial performance of the department, hotel, or restaurant and is used as a management tool to improve operations. Managers should be focused on effectively managing their operations to produce the budgeted or forecasted results. The P&L results for a month help them review and evaluate actual performance and to plan on future performance.

Hospitality managers use the company's working capital (Balance Sheet amounts) in their daily operations. They primarily use the current assets of the company. They spend cash to purchase inventories (current asset, CA) or pay employee wages (current liability, CL) to produce products and services. They are expected to manage these accounts or expenditures according to budgets or company procedures. Working capital is both the amount a hotel or restaurant manager has to utilize for daily operations and the amount or balance in the cash account that is not spent and available for operations. Effectively managing the working capital in daily operations maximizes the working capital that is uncommitted and available for ongoing operations. Refer to the business operating cycle shown in Figure 5.1 to visualize these relationships.

Follow the arrows to see the flow of working capital in daily operations. The working capital provides current assets to produce products and services for customers. Notice that everything starts with the cash account. Current assets and operating expenses use cash. Inventory is a balance sheet current asset, and wages and benefits are operating expenses on the P&L Statement that are used to produce products and services. Production uses assets and incurred expenses.

When the sale occurs, cash payments are deposited directly into the cash account. Credit card sales go briefly into accounts receivable and then into the cash account when the electronic transfer of funds is received. Direct billing sales go to accounts receivable where they stay until the account is paid. Thirty-day accounts are acceptable, but accounts unpaid that are 30 to 60 days, 60 to 90 days, or more than 90 days tie up cash and put a strain on cash flow.

The more efficient a company uses its assets and the quicker it collects its sales, the better the cash flow and financial soundness of the company.

Several of the accounts in Figure 5.1 are revenue and expense accounts that are part of the P&L Statement. For example, the amount of wages payable (CL) on the A&L is determined by the amount managers spend in management, hourly, and overtime labor costs. These costs are immediately recognized on the P&L as expenses incurred in providing products and services to customers. The cost is recognized on the Balance Sheet as wages payable (CL) until the paychecks are written, issued, and cashed by employees. At that time, wages payable are decreased and the cash account is decreased. So the time associated with an accounting transaction is different for the P&L and Balance Sheet, but they will all be included in the same time period, usually a month or accounting period. The wage expense on the P&L is *for the month or accounting period*, and the cash and accounts payable are *at the end of the month or the end of the accounting period*.

The same relationship exists for inventories and operating expense. When a manager purchases guest supplies and linen for the Rooms Department, it will increase the rooms guest supplies and rooms linen inventory accounts when the supplies are received. The total expense is then recognized as accounts payable until the manager receives, approves, and sends the invoice to accounting for payment. When accounts payable sends out the check, accounts payable decreases and the cash account is decreased. At this point, the transactions only affect the Balance Sheet accounts—inventory (CA) and accounts payable (CL).

Step 1 Transaction when inventory is purchased—Increase inventory and increase accounts payable.

Step 2 Transaction when invoice is paid—Decrease accounts payable and decrease cash.

When the supplies are taken out of inventory and put into operations, the corresponding P&L expense accounts are charged. For example, if $2,000 of linen and $1,000 in guest supplies are taken out of inventory and put into operations, the inventory accounts are decreased by those amounts, and $2,000 is charged to the linen operating expense account and $1,000 is charged to the guest supply operating expense account on the Rooms Department P&L Statement.

Linen transaction	Decrease linen inventory account (CA)	–$2,000
	Increase linen expense account (P&L)	+$2,000
Guest supply transaction	Decrease guest supply inventory (CA)	–$1,000
	Increase guest supply expense account (P&L)	+$1,000

Differences and Similarities between the Balance Sheet and the P&L

Let's take some time to review the characteristics and transactions that affect the P&L Statement and the Balance Sheet.

Differences

1. The P&L shows financial transactions *over a period of time* like a month or year. The Balance Sheet shows financial information *at a specific time or date* like the end of the month or end of the year.

2. The P&L records revenues, expenses, and profit *amounts* incurred or spent during a specific time period. The Balance Sheet records account *amounts or balances* at the end of a specific time period.
3. The P&L *accumulates and totals* revenues received and expenses incurred over the month or accounting period. A new month starts with zero balances on the P&L. The balance sheet *records account activity* during the month or accounting period and the balance remaining at the end of the month.
4. The P&L is used by hospitality managers in operating their departments, and it measures the financial performance of the department. The Balance Sheet is also used by hospitality managers in operating their department, and it is also used by owners, investors, and outside financial institutions in evaluating the value and net worth of a business.

Similarities

1. Both statements are subject to generally accepted accounting principles (GAAP).
2. The hotel accounting department or corporate accounting department prepares both financial statements.
3. Both statements have accounts that are used as working capital.

The Statement of Cash Flow

The **Statement of Cash Flow** is the third financial statement used in measuring the financial performance of a company. It focuses on two areas of company operations. First is the cash account on the Balance Sheet. It identifies the movement of cash in and out of the cash account and the amount of beginning and ending cash balances are maintained. Liquidity is the key term and measurement. Second is the source and use of funds generated by the company in using accounts on the Balance Sheet in daily operations. Working capital is the key term and measurement.

Definition

The Statement of Cash Flow measures the amount of cash a company has and how cash flows through the company during the course of daily operations. The primary source of cash should be the revenues generated by the operations of a company or business. It should be sufficient to cover all expenses incurred to produce products, services, and profit. Key characteristics of the Statement of Cash Flow 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 a 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.

Cash Flow and Liquidity

Several key elements of measuring and managing cash are important for hospitality students to know and understand. A business must pay as much attention to managing cash and maintaining sufficient cash balances as it pays to making an operating profit.

Cash Flow

The main reason that the cash account on the Balance Sheet is so important is that a company must maintain a large enough balance in its cash account to pay all operating expenses in a timely and efficient manner. Purchases of supplies and materials from vendors, payment of wages to employees, and paying long-term obligations such as bank loans on time are critical to the success of a company. The hotel's Director of Finance is responsible for managing the cash account so that no disbursements are made in payment of obligations unless there is money in the cash account to cover these expenses and obligations.

Cash increases come through revenues recorded on the P&L Statement as a result of operating activities. Specifically, the cash account increases with the daily hotel deposit of cash, traveler's checks, and individual or company checks received in payment of products and services provided by the hotel and directly billed to the customer. Each day, the hotel also receives electronic cash transfers directly into its cash account from the credit card companies in payment of guest accounts paid by credit card. Last, specific accounts billed directly to individual guests or companies progress through the accounts receivable cycle until the bill is approved by the customer/company and a check is processed and mailed to the hotel in payment of amounts owed the hotel.

Cash is a current asset on the Balance Sheet, so it always will have a beginning balance at the beginning of the month, activity during the month, and an ending balance at the end of the month. This activity in the cash account represents the cash flow of a company.

Liquidity

Liquidity refers to the amount of cash or cash equivalents that a company has to cover its daily operating expenses and that it maintains in its cash or cash equivalent accounts on the Balance Sheet. This includes the length of time it will generally take to convert a Balance Sheet account to cash. A short conversion time period reflects a liquid asset. A long conversion time period reflects a nonliquid asset. Let's look at some examples of asset accounts on the Balance Sheet that illustrate liquidity:

- *Cash.* **Cash** is the most liquid asset of all. It is available for immediate use.
- *Cash equivalents.* The next most liquid asset. These are current assets that can be converted to cash in a matter of hours—for example, 24 to 48 hours. Common stock, company and Treasury bonds, certificates of deposit, and overnight investments are examples of cash equivalents. They can be sold, and the receipts are usually deposited into the cash account within a matter of days.
- *Liquid assets.* Accounts that are on their way to becoming cash. Accounts receivable are an example of a liquid asset. The sale has been made, the invoice has been sent to the buyer, and payment is in the process of being made. Receipt of payment and deposit in the cash account can occur in a matter of days or weeks. The point to remember is that the next transaction of a liquid asset is that of being deposited into the cash account.
- *Nonliquid asset.* Accounts that are not close to being turned into cash. Inventory is an example of a nonliquid current asset. The fact that money is tied up in inventory means that it has not been sold yet. In fact, there are three categories of inventory reflecting three stages of liquidity:

  Finished goods. Inventory of assembled and completed products at the manufacturing plant that are waiting to be shipped, on the shelves of a distributor ready to be shipped to retail outlets, or on the shelves of retail outlets ready to be sold to customers.

  Work-in-process. Inventory that is in the process of being assembled into a final product. It is no longer raw material and will soon be finished goods.

  Raw materials. Inventory that has not been used yet to produce a product. It is sitting on shelves in the warehouse or in piles in the stockyard. It is a long way from being converted into cash.

  Generally, no estimates are made of when inventory will be converted to cash because of the status and many variables involved in managing inventories. Finished goods are much closer to being converted into sales and cash than work in process or raw materials. Finished goods are more liquid than raw materials or work in process.
- *Long-term assets.* Assets that are not intended to be converted into cash but to be used in the daily operations of the company over an extended period of time. They are involved in the capitalization of a company and represent assets that have a longer life, generally 1 to 50 years. They will only be sold or replaced when they are worn out, outdated, or fully depreciated.

It is important for a company to maintain acceptable levels of liquidity. Each industry has a set standard that identifies the amount of cash or cash equivalents that a company should maintain to have acceptable levels of liquidity. Two of those measures are working capital and the current ratio. Working capital is defined as current assets minus current liabilities. It implies that a company should have a higher amount of current assets than current liabilities. This means that the company owns more current assets than it owes in current liabilities. It is important to look at the direction or trend of working capital from month to month. Is it getting larger and stronger, or is it getting smaller and becoming a concern or a problem?

The current ratio is current assets divided by current liabilities and expresses this relationship in terms of a percentage. Again, a company would like a current ratio of more than 1, because that means that the company has more current assets than current liabilities. It is also important to look at the direction in which the current ratio is moving. Is it getting stronger or weaker? Is it high and safe or low and not safe? Industry standards will be applied to a company's current ratio to determine if it is acceptable and moving in the right direction or not.

We will use the financial information in Exhibit 5.1 to illustrate working capital and calculate the current ratio.

$$\begin{aligned}
\textit{Working Capital} &= \textit{Current Assets} - \textit{Current Liabilities}\\
&= \$205 - \$125\\
&= \$80\\
\textit{Current Ratio} &= \textit{Current Assets} \div \textit{Current Liabilities}\\
&= \$205 \div \$125\\
&= 1.64
\end{aligned}$$

Classification of Cash Flow

Cash flow activities are classified into three main categories that describe the nature of the cash inflow or outflow: (1) operating activities, (2) investing activities, and (3) financing activities. Hospitality managers are primarily involved in the operating activity but should have a good understanding of financing and investing activities.

Operating activities include *cash inflow*, primarily from the sale of products and services to guests. This is the main reason for the existence of a company or business and is therefore the most important cash flow activity. Hospitality managers are directly involved in maximizing hotel and restaurant revenues. *Cash outflow* involving operating activities includes the payment of wages and benefits to employees, the payment for supplies and materials to vendors, and the payment of taxes and other expenses to appropriate agencies. Hospitality managers, again, are directly involved in managing and controlling expenses to maximize profitability, which should also result in the creation of a strong positive cash flow.

Investing activities include cash outflow that involves purchasing long-term assets or investing in marketable securities. When these investments are reversed, cash inflow is created. For example, if older equipment is sold or property is sold, this results in cash being received and deposited in the cash account; therefore this is a cash inflow. The same occurs when marketable securities are sold and cash is received, and deposited in the cash account. The Director of Finance, along with corporate senior management, is primarily involved with investing activities.

Financing activities involve the creation or use of cash for capitalization purposes. Cash inflow results from selling common stock or obtaining a bank loan. The cash account goes up. Cash outflow results from purchasing common stock or the repayment of a bank loan. The cash account is decreased, and the funds are used to buy the common stock or to repay the bank loan. Financing activities primarily involve the owner and management company working with the Director of Finance and General Manager in conducting financing activities.

Source and Use of Funds Statement

The **Source and Use of Funds Statement** is part of the Statement of Cash Flow and shows how cash is created or used among the different accounts on the Balance Sheet. It involves the changes in the balances of all the accounts on the Balance Sheet. It will be helpful to refer back to the Fundamental Accounting Equation in discussing the changes in individual balance sheet accounts that result in a source of funds or a use of funds.

Assets = Liabilities + Owner Equity

Let's begin with the following table, which separates sources and uses of funds and thereby demonstrates increases or decreases in the accounts.

Sources	Uses
1. Decreases in asset accounts	1. Increases in asset accounts
2. Increases in liability accounts	2. Decreases in liability accounts
3. Increases in owner equity accounts	3. Decreases in owner equity accounts

Sources of Cash

A decrease in an asset account means that the asset balance has gone down or declined and less money is contained in that account. For example, collecting $5,000 in accounts receivable (CA) means that accounts receivable is now $5,000 lower. The offsetting/balancing entry is cash (CA), which increases $5,000. The decrease in accounts receivable is a source of funds or a source of cash. Another example is when food inventory (CA) of $3,000 is put into production. The accounting entry is a $3,000 decrease in inventory that was sold and a $3,000 increase in food cost on the P&L. Again, the decrease in inventory creates a source of funds. In both examples, money was freed up from a current asset account, which generated a source of funds.

An increase in liabilities also is a source of cash and means that the amount owed vendors or other companies has increased. Therefore it is a source of cash because the actual cash disbursement has been delayed.

An increase in owner equity is also a source of cash. This means that owners have made additional contributions to the company in the paid-in capital account or that individual investors have bought more of the common stock of the company or that retained earnings have increased as a result of operating profits. All of these transactions are a source of cash because the amount invested in the company in owner equity accounts has increased. For each of these transactions, the corresponding accounting entry is an increase in the cash account—a source of funds.

Uses of Cash

An increase in an asset account means that the balance in that account has gone up, which requires a cash outlay. For example, the company purchases and pays for $10,000 in materials, which increases the inventory account. That is a use of funds because $10,000 is used to purchase materials and increase inventory.

A decrease in liabilities is a use of cash and means the amount owed vendors or other companies has decreased because the company has made a payment to them. Using the same $10,000 inventory purchase example but not paying cash results in the following transactions:

Inventory + $10,000   Accounts Payable + $10,000

This part of the transaction is a source of funds because we the company *has not paid the $10,000 invoice*. The second part of the transaction, when the company pays the invoice, is represented this way:

Accounts Payable – $10,000   Cash – $10,000

This is a use of cash. When the decrease in accounts payable occurs, that is the time when the transaction is a use of funds.

A decrease in owner equity is a use of cash. This means that the paid-in capital account has decreased because one or several of the owners have taken money out of the account in the form of a cash disbursement. A decrease in the common stock account means that investors have sold the stock, resulting in a cash disbursement. The final activity is a decrease in retained earnings, which means that the company had an operating loss and money was taken from the retained earnings account to cover the loss. This also is a cash disbursement. In each of these owner equity transactions, the account value decreased, requiring a corresponding decrease in cash as cash was disbursed or paid to cover the transaction.

Summary

The Balance Sheet is the financial statement that measures a company's value or net worth as of a specific date in time. It is also called the Asset and Liability (A&L) Statement. The Balance Sheet is organized according to the fundamental accounting equation:

Assets = Liabilities + Owner Equity

Assets are resources or what a company owns.

Liabilities are debts a company owes.

Owner equity is who owns a company.

The main characteristics of a Balance Sheet are the following:

1. It measures the value or net worth of a company at a specific date in time.
2. The Fundamental Accounting Equation describes the Balance Sheet:

   Assets = Liabilities + Owner Equity
3. It is divided into current and long-term accounts.
4. It has beginning balances, monthly activity, and ending balances.
5. It has monthly activity including increases and decreases.
6. The value of the asset side of the Balance Sheet must equal the value of the Liability and Owner Equity side of the Balance Sheet.

Capitalization refers to the way a company or business obtains and uses money to start or expand the business. It involves obtaining long-term debt or raising funds from investors by way of paid-in capital or common stock. Working capital is the amount of funds used by a business in its daily operations and is defined as current assets minus current liabilities. Hospitality managers use the assets in the Balance Sheet accounts in the daily operations of their departments.

The Statement of Cash Flow identifies the movement of cash in and out of the cash account in the daily operations of a business. It measures the amount of cash available and identifies how it is used. The cash account is the most important current asset account because it is used to purchase the other assets required to produce the products and services, and it is used to pay all operating expenses including the salaries and wages of employees making the products and services.

Cash flow activities are divided into three categories: operating activities, financing activities, and investing activities. Hospitality managers are primarily involved in operating activities as they manage their departments.

Liquidity is an important measurement of cash flow. It is the amount of cash or cash equivalents that a company has to cover its daily operating expenses. The dollar amount available in the cash account is immediately available for use in company operations and requires no time for conversion into the cash account.

Hospitality Manager Takeaways

1. **It is important for hospitality managers to have a general understanding of the Balance Sheet and Statement of Cash Flow. The daily operation of their department will affect both statements.**
2. **Working capital is the accounts on the Balance Sheet that hospitality managers use on a daily basis—primarily cash, inventories, and accounts payable.**
3. **Hospitality managers must understand the importance of liquidity, which is the ability to maintain sufficient cash account balances to pay all debts and operating responsibilities.**
4. **It is important for hospitality managers to understand the basic characteristics of the Balance Sheet and Statement of Cash Flow and be able to have a positive impact on them through the daily operations of their departments.**

Key Terms

Accounts Payable—Products or services received by a company but not paid for that are due within one year.

Accounts Receivable—What the company is owed for providing products and services to customers. Revenues recorded but uncollected.

Assets—The resources owned by a company that are used by that company in the production of products and services.

Current—Assets that are used or consumed during a one-year time period.

Long Term—Assets with a useful life of longer than one year.

Balance Sheet—The financial statement that measures the value or net worth of a business as of a specific date. Also called the Asset and Liability (A&L) Statement.

Cash—Funds that are in the cash account and available for use in daily business operations.

Classifications of Cash Flow—Operating activities, financial activities, and investment activities.

Fundamental Accounting Equation—Assets = Liabilities + Owner Equity.

Inventory—Assets in the form of materials and supplies that the company has purchased but not yet used in the production of products and services.

Liabilities—Obligations owed by a company.

Current—Obligations that are due within one year.

Long Term—Obligations that are due longer than one year from the current date.

Owner Equity—The amount invested in a company by owners or investors including paid-in capital, common stock, and retained earnings.

Source and Use of Funds Statement—A part of the statement of cash flow that shows how funds are created (source) and disbursed (used) among the different accounts on the balance sheet.

Statement of Cash Flow—Measures the liquidity and identifies the flow of cash in a company.

Review Questions

1. Explain the financial information contained in a Balance Sheet, and explain how it is used.
2. Describe working capital and capitalization, and explain what each is used for. Include the Balance Sheet accounts that are used in each process.
3. What accounts on the Balance Sheet will hospitality managers generally use in the daily operations of their departments?
4. List five characteristics of the Balance Sheet.
5. Compare and contrast liquidity with profitability.
6. Name the three classifications of cash flow.
7. Name three changes in Balance Sheet accounts that are a source of funds and three that are a use of funds.
8. Why is an increase in accounts payable a source of funds? Give an example.
9. List four characteristics of the Statement of Cash Flow.