

# FINANCE FOR THE NON-FINANCIAL MANAGER: FINAL CHAPTER

By Tanya Venegas,  
MBA, MHM



*Third in a series: Finishing up with multiple topics, including ratio analysis, departmental payroll titles, expense dictionary, statement of owner's equity and HFTP member questions*

## Ratio Analysis

Oftentimes, stakeholders want to see in-depth analysis of financial statements and ratio analysis as one of the ways to analyze the well-being of the organization. The following ratios provide a look at the organization and how it is operating and can be used for any type of business— club, hotel, restaurant, etc.

### Liquidity Ratios

Liquidity ratios measure an organization's ability to meet its short-term financial obligations. Examples of liquidity ratios include the current ratio, acid-test ratio and accounts receivable turnover ratio.

Current Ratio = Current Assets / Current Liabilities
Acid-Test Ratio = Quick Assets* / Current Liabilities
Accounts Receivable Turnover = Total Revenue / Average Accounts Receivable

\* Quick Assets are calculated by subtracting inventories and prepaid expenses from current assets.

### Solvency Ratios

Solvency ratios determine the operations ability to meet its long-term obligations by measuring the degree of debt financing used by the company. Examples of solvency ratios include debt-equity ratio and debt service coverage ratio. Solvency ratios have been greatly scrutinized due to the downturn in the economy. Most debt covenants require a certain debt service coverage ratio and many companies are not making the mark because their net operating income has declined.

Solvency Ratio = Total Assets / Total Liabilities
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Debt-Equity Ratio = Total Liabilities / Total Owners' Equity
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Debt Service Coverage Ratio = Adjusted Net Operating Income / Debt Service
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### Activity Ratios

Activity ratios measure management's ability to produce income utilizing the resources that they are provided. One of the primary measurements in this area is inventory turnover.

Food Inventory Turnover = Cost of Food Sales / Average Food Inventory
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### Profitability Ratios

Profitability ratios allow organizations to compare bottom line profits against their competitors. Examples of profitability ratios include gross operating profit margin, income before fixed charges margin ratio and net operating income margin ratio.

Gross Operating Profit Margin Ratio = Gross Operating Profit / Total Revenue
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Income Before Fixed Charge Margin Ratio = Income Before Fixed Charges / Total Revenue
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Net Operating Income Margin Ratio = Net Operating Income / Total Revenue
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Tanya Venegas, MBA, MHM is program director of the HFTP Research Institute at the University of Houston and frequent speaker at HFTP educational events.

## Operating Ratios

Operating ratios allow owners and managers to analyze the relationship between revenues and expenses for an operation. These calculations can be used as a control by comparing against budgeted amounts, industry standards and competitors. Operating ratios will vary depending on the type of property. For example, hotel properties would look at room rates and occupancy percentages while golf clubs would focus on rounds of golf.

Average Food Check =  
Total Food Revenue / Number of Covers

Food Cost Percentage =  
Cost of Food Sales / Food Revenue

Beverage Cost Percentage =  
Cost of Beverage Sales / Beverage Revenue

Labor Cost Percentage =  
Total Payroll and Related Expenses / Total Revenue

## Departmental Payroll Titles

Included in the *USALI* is a section which discusses departmental payroll titles. This section is useful when comparing common titles in departments such as rooms, accounting, purchasing, and information systems. Many organizations have their own variations of titles for positions. One example would be for individuals working on information systems at the property level. According to the *USALI*, common titles in this department include director of information systems, MIS manager, systems manager, systems analyst, programmer and computer operator (2006).

## Expense Dictionary

The expense dictionary is a useful tool for hospitality accounting managers. An expense dictionary is included in the *Uniform System of Accounts for the Lodging Industry (USALI)*, *Uniform System of Financial Reporting for Clubs (USFRC)* and other uniform systems such as for spas and restaurants. The purpose of the expense dictionary is to assist hospitality managers in classifying expense items. Managers can look up the name of the item and the department/schedule is listed along with the account name. Unfortunately, every individual item may not be included in the expense dictionary, but it provides guidelines to assist accounting managers in account classification. It is important to appropriately classify items for comparability purposes.

## Statement of Owner's Equity

The purpose of the Statement of Owners' Equity is to show the changes in owners' equity over a specified period of time. According to the *Uniform System of Accounts for the Lodging Industry (USALI) 10th edition*, a separate statement of owners' equity must be presented if there is significant activity in the equity accounts during the period (2006). The change in owners' equity can be included in the Statement of Income if net income or loss is the only change experienced in the equity accounts.

The Statement of Owners' Equity is also known as the statement of retained earnings, equity statement or statement of shareholders' equity. Typically, the name is dependent on the structure of the company. For example, the statement of shareholders' equity title would be used by a corporation in which investors hold shares. The *USALI* outlines several different versions of the Statement of Owners' Equity which can be used depending on the type of entity. An example can be found accompanying this article (page 16). The Statement of Stockholders' Equity is the most complicated form, because of the different equity types: preferred stock, common stock, additional paid-in capital and treasury stock. The statements for partnerships, members and sole proprietorships are much simpler and only have slight variations.

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### Finance for the Non-financial Manager

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- Statement of Cash Flow,
- Benchmarking,
- Statements of Income, and
- Balance Sheets



## Statement of Owner's Equity *(continued)*

### EXAMPLE. Statement of Owner's Equity

	Owner	Total
<b>Balance at the Beginning of Prior Year</b>	\$	\$
<b>Add (Deduct)</b>		
Net Income		
Contributions		
Change in Unrealized Gains (Losses)		
Withdrawals		
Other		
<b>Balance at End of Prior Year</b>	\$	\$
<b>Add (Deduct)</b>		
Net Income		
Contributions		
Change in Unrealized Gains (Losses)		
Withdrawals		
Other		
<b>Balance at End of Current Year</b>	\$	\$

### DEFINITIONS.

#### Accumulated Other Comprehensive Income

Accumulated Other Comprehensive Income represents gains and losses that have yet to be realized.

#### Additional Paid in Capital

Is the difference between the par-value of a common stock and its purchase price.

#### Common Stock

Common stockholders own a portion of a corporation, have the ability to elect the board of directors, and set corporate policies. On the downside, common stockholders are at the bottom when it comes to claims to the company's assets at liquidation.

#### Dividends Declared

When dividends are declared, retained earnings is reduced because this is considered a distribution to shareholders.

#### Net Income

Income that remains after subtracting costs (operating, depreciation, interest and taxes) from the company's revenues. This can also be referred to as earnings or net profit.

#### Preferred Stock

Preferred shareholders have priority over common shareholders when it comes to earnings and assets at liquidation and typically earn a fixed dividend which is paid before common shareholders receive dividends. On the downside, preferred stockholders typically do not have voting rights and do not have as much earning potential as common stockholders.

#### Retained Earnings

Retained earnings are the percentage of net earnings which is retained by the company to reinvest and grow its core business.

#### Treasury Stock

Treasury stock is shares that the company currently owns which were either repurchased or were never offered to the public for purchase.

#### Unrealized Gains (Losses)

A profit or loss that results from holding onto an asset rather than selling it.

## HFTP Member Questions

HFTP members were asked to supply questions that they often receive pertaining to financial statements. These questions are briefly answered below. For more in-depth answers you can contact the HFTP Research Institute.

*Can you explain the difference between a capital and operating expense?*

A capital expense is one that results in an economic benefit of greater than one year. Capital expenses include land, buildings and most equipment. Expenses should also be considered capital expenditures if it significantly extends the life or increases the value of the item. Operating expenses are those which a business incurs while performing normal daily operations such as utilities, salaries and other basic operating costs.

*Can you please explain accruals and how they apply to payroll?*

There are two basic accounting systems: cash or accrual. Cash basis accounting only records cash transactions, but accrual accounting allows companies to record items such as accounts receivable, accounts payable and future tax expenses. Accrual accounting allows the company to see the big picture and know what expenses are on the horizon and the revenues which will be received. It also allows a company to match expenses to the appropriate period of time.

How does this apply to payroll? Here is a simple example. Johnny works at the front desk for ABC Hotel. Johnny receives a paycheck every two weeks; therefore, the hotel needs to set aside the money that Johnny is earning along with any taxes that need to be paid. Money which will be paid to Johnny can easily be recorded on the balance sheet as a liability by debiting an account such as wage expense and crediting a current liability such as accrued payroll. Accruals also allow accountants to match payroll to the appropriate time period. If Johnny's paycheck spans two months, than the proportionate amount of payroll needs to be recorded in each month. That allows the business to match revenues to expenses.

*Please provide an explanation for depreciation and why it has to be done.*

Depreciation is an expense which matches the expense of the asset to the revenue which the asset will help produce. In addition, depreciation is a non-cash expense that will decrease earnings and increase free cash flow over time. For example, a restaurant may purchase an ice machine for \$5,000. The expected useful life of the unit is seven years; therefore, it will be used for seven years to provide guests with ice for their beverages and used for various purposes in the kitchen. Depreciation for the ice machine would then be recorded over a seven year period.

*How can the percentage of sales calculation be used as a financial tool and what does it mean in a departmental P&L?*

When analyzing the Profit & Loss Statement (P&L) or Statement of Income, percentage of sales can be a powerful tool. In general, this allows an organization to see where revenues are originating and what portion of these revenues is eaten up by expenses. The following is a simple example of percentages of sales for departmental revenues and expenses. First of all, examine the top portion containing revenues. These figures were all calculated using total revenues; therefore, they add up to 100 percent.

Hotel ABC	Percentages
<b>Revenues</b>	
Rooms	65
F&B	25
Telecommunications	1
Other Operated Departments	9
TOTAL	100
<b>Expenses</b>	
Rooms	27
F&B	68
Telecommunications	101
Other Operated Departments	5
TOTAL	42

The second section contains expenses as a percentage of departmental revenues, which is the reason the expense totals do not add up to 100 percent. For example, the percentage for room's department expenses was calculated by dividing room's expenses by room's revenue totaling 27 percent. This allows managers to analyze what percentage of revenues is being used to create sales. Finally, when you get down to total expenses it is calculated using total sales. Then departmental profit can be calculated by subtracting total expenses (42 percent) from total revenues (100 percent) resulting in departmental profit of 58 percent.

The above questions were covered in a brief manner. For further information on any of the topics in this article contact the HFTP Research Institute. ■

### Sources

- Hotel Association of New York City, Inc. (2006). *Uniform System of Accounts for the Lodging Industry, 10 ed.* American Hotel & Lodging Educational Institute, Lansing, MI.