



Basic Management Accounting for the Hospitality Industry

Michael N. Chibili

Second edition

Noordhoff Uitgevers Groningen | Houten



Preface to the second edition

Welcome to the second edition of *Basic Management Accounting for the Hospitality Industry* that includes several changes. These changes have been driven by all the responses and comments from both colleagues who are using its first edition, as well as the students who used it. Many thanks are due to all of them for their useful and constructive ideas, comments and feedback that have contributed to what I hope will be an improved edition.

The foremost changes content-wise are as follows:

- 1 The changes that have affected financial statements due to the evolution of the Uniform System of Accounts for the Lodging Industry (USALI) from its 10th edition to the 11th edition have been taken into account in the major financial statements especially as they affect the contents of Chapter 3 and Chapter 5.
- 2 The essence of the International Financial Reporting Standards (IFRS) has now been more infused into the text.
- 3 Additional relevant ratios have been integrated into, while redundant ones (due to the changes in the USALI) have been removed from the text especially in Chapter 7, and the performance review process has been simplified.
- 4 The Cash Conversion Cycle has been included and illustrated in Chapter 8.
- 5 Information on price elasticity of demand has been extended in Chapter 10 with additional information related to income and cross elasticities.
- 6 Risk and uncertainty analyses has been extended, and the weighted average cost of capital (WACC) has been included.
- 7 The Break-even Time (BET) has been included as one of the methods of analysing capital investments.
- 8 Where appropriate, the tables have been updated.

I believe that this up-to-date and comprehensive coverage of basic management accounting within the hospitality industry makes this second edition an essential addition to the library of any hospitality management student. It is my hope that students and lecturers alike will find it to be a significant contribution to the field of hospitality management education and keep on ensuring its continued success.

Michael N. Chibili
September 2015

Table of contents

1	Introduction to management accounting	15
1.1	Setting the scene	16
1.1.1	Information needs – management and external users	16
1.1.2	Financial accounting and management accounting	17
1.1.3	Basic principles of accounting	18
1.1.4	The management accounting process	21
1.2	Understand the hospitality industry	22
1.2.1	The nature of the hospitality industry	22
1.2.1.1	Goods and services offered	23
1.2.1.2	The distinguishing features	26
1.2.2	Industry organization and recent developments	27
1.2.3	Summary of the key characteristics of the hospitality industry	28
	Glossary	29
	Multiple choice questions	31
	Exercises	31
2	The balance sheet	35
2.1	The components of a balance sheet	36
2.1.1	Assets	36
2.1.2	Liabilities	40
2.1.2.1	Current liabilities	40
2.1.2.2	Long term liabilities	42
2.1.3	Owners' equity	43
2.2	Formats of balance sheets	46
2.3	Establishing simple balance sheets	47
2.4	The Statement of Retained Earnings	50
	Glossary	52
	Multiple choice questions	54
	Exercises	54
3	The profit and loss account statement	57
3.1	Definition and categories of activities	58
3.2	Formats and content of the profit and loss account statements	60
	Glossary	67
	Multiple choice questions	68
	Exercises	68
4	Adjustments to the balance sheet and the profit and loss account	71
4.1	Accounting conventions – accruals and recognition	72
4.2	Adjusting the accounts	72
4.2.1	Stock (inventory)	72
4.2.2	Accounts receivable	74
4.2.3	Depreciation and amortization	75
4.2.4	Returns of goods	76
4.2.5	Discounts	77

4.2.6	Delivery charges 77 Glossary 78 Multiple choice questions 79 Exercises 79
5	The cash flow statement (also called the statement of cash flow) 81
5.1	Cash in the business 82
5.1.1	The importance of cash in the business 82
5.1.2	Differentiating profits from cash 83
5.1.3	The need for cash flow statements 83
5.1.4	Categories of activities 84
5.2	Establishing cash flow statements 86
5.2.1	Determine the net cash flow from operating activities 86
5.2.2	Determine the net cash flow from investing activities 88
5.2.3	Determine the net cash flow from financing activities 89
5.2.4	Collate all the previous 3 net cash flows into the definitive SCF 89
5.3	A worked example in the establishment of the SCF using the indirect method 89 Glossary 95 Multiple choice questions 96 Exercises 96
6	Analyzing financial statements 99
6.1	Purposes of analyzing statements 100
6.2	Horizontal analysis 105
6.3	Base-year analysis 107
6.4	Vertical analysis 108 Glossary 112 Multiple choice questions 113 Exercises 113
7	Ratio analysis and types of ratios 117
7.1	Purpose and usefulness of ratio analysis 118
7.2	Classification of ratios 119
7.2.1	Liquidity ratios 120
7.2.2	Solvency ratios 122
7.2.3	Profitability ratios 124
7.2.4	Activity ratios 131
7.2.5	Operating ratios 134
7.3	Performance review process 136
7.4	DuPont analysis 138 Glossary 141 Multiple choice questions 146 Exercises 146
8	Management of working capital 149
8.1	The importance of working capital management 150
8.2	The working capital cycle 150 Glossary 160 Multiple choice questions 161 Exercises 161

9	Cost management 165
9.1	The nature of costs and assumptions 166
9.2	Types of costs 166
9.3	Activity-based costing 169
9.4	Allocating indirect (overhead) costs to the operating departments 172
9.4.1	Responsibility accounting 172
9.4.2	Determining allocation bases 173
9.4.3	Common methods of cost allocation 174
9.4.4	Illustration of the direct method of cost allocation 176
9.4.5	Illustration of the step method of cost allocation 178
9.5	Separating mixed-costs between their fixed and variable elements 181
9.5.1	High/low two-point method 182
9.5.2	Scatter diagram 185
9.5.3	Regression analysis 186
	Glossary 189
	Multiple choice questions 191
	Exercises 191
10	Pricing and Revenue Management 195
10.1	The importance of pricing and the relationship between price and quantity 196
10.2	Approaches to pricing 202
10.3	Pricing rooms 203
10.3.1	The rule of a thousand approach 203
10.3.2	The bottom up approach (Hubbart formula or required rate of return) 203
10.3.3	Relative room size approach 205
10.3.4	Differential room pricing 207
10.3.4.1	Calculating single and double rates 207
10.3.4.2	Integrating the effects of seasonality 209
10.3.5	Room rate discounting 210
10.4	Pricing food and beverage products 212
10.4.1	Subjective pricing methods 213
10.4.1.1	The reasonable price method 213
10.4.1.2	The highest price method 213
10.4.1.3	The loss leader method 213
10.4.1.4	The intuitive price method 213
10.4.2	Objective pricing methods 213
10.4.2.1	Using a mark-up multiplier 214
10.4.2.2	Contribution margin pricing method 217
10.4.2.3	Ratio pricing method 218
10.4.2.4	Simple prime costs method 219
10.4.2.5	Specific prime costs method 221
10.5	Menu engineering 225
10.6	Revenue management 229
	Glossary 232
	Multiple choice questions 234
	Exercises 234
11	Cost-volume-profit analysis 237
11.1	Definition, assumptions and limitations 238
11.2	Contribution margin 238
11.3	Breakeven analysis 239
11.3.1	Establishing the breakeven point 239
11.3.2	Single service analysis 240

11.3.3	Other considerations in breakeven analysis	243
11.3.3.1	First situation – two room types	243
11.3.3.2	Second situation – two room types plus additional services	244
11.3.3.3	Third situation – integrating desired profit levels	246
	Glossary	248
	Multiple choice questions	249
	Exercises	249
12	Internal control	251
12.1	Need for internal control	252
12.2	Special characteristics of the hospitality industry from an internal control perspective	253
12.3	Principles of internal control	254
12.4	Basic internal control proposals	259
12.5	Bank reconciliation	267
	Glossary	270
	Multiple choice questions	271
	Exercises	271
13	Forecasting	273
13.1	Nature and limitations of forecasting	274
13.2	Understanding historical data patterns	275
13.3	Approaches to forecasting	276
13.3.1	Qualitative forecasting methods	277
13.3.2	Quantitative forecasting methods	277
13.3.2.1	Time series forecasting methods	278
13.3.2.2	Causal forecasting methods	281
13.4	Selecting forecasting methods	283
13.5	Forecasting in hospitality industry practice	284
	Glossary	285
	Multiple choice questions	287
	Exercises	287
14	Budgeting and variance analysis	291
14.1	The budget and the budget process	292
14.2	Objectives of budgeting	293
14.3	Approaches to budgeting and types of budgets	294
14.4	Types of budgets	298
14.5	Variance analysis	300
14.5.1	Identifying and attributing variances	300
14.5.2	Variance analysis overview	301
14.5.3	Analyzing variances to ascertain causes	302
	Glossary	308
	Multiple choice questions	310
	Exercises	310
15	Capital investment decisions	313
15.1	Types of capital budgeting decisions	314
15.2	Basic methods for making investment decisions	315
15.3	Simple and compound interest	320
15.4	Process of discounting	322
15.5	Understanding factor tables	323
15.6	Discounted cash flow (DCF) methods	332

- 15.7 Incidence of taxes on DCF analysis 344
- 15.8 Choosing between projects 348
 - Glossary 350
 - Multiple choice questions 352
 - Exercises 352

References for further reading 355

Answers to end of chapter multiple choice questions 357

Appendix Factor tables 359

About the author 372

Picture credits 373

Index 374