

Finance and accounting in the hospitality industry



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Introduction.

According to the Barrows & Powers (2009, pp. 3-5) hospitality industry has included hotels , restaurants and other related organisations to the food industry and it has given more emphasis on providing customer sensitive products and services in order to gain profitability and customer satisfaction. Hence, the application of finance and accounting has been done a great deal to achieve such requirements for the hospitality industry.

The applications of finance in the hospitality industry has been discussed under several ways of this assignment. Further it has focused to understand the sources of funding and income generation for the business and services industries as well as understand the business in terms of the element of cost. In addition that it has given more intention to evaluate the financial statements of the selected businesses which are in the hospitality industry. Apart from that, this has emphasise the analysis of the performance of the business by using ratio analysis techniques. Finally it has focused to apply the marginal costing concept to evaluate the short term management decisions.

Task – 01.

01. 1 Sources of funding available to business and service industries.

Sources of funds are very important to decide management decisions as well as long term strategies of any organisation. As per the Sharan (2005, pp. 210-218) following funding methods should be noted.

Retain Profits.

Increasing the revenue and reducing the cost this can be increased in a systematic manner.

Bank Loans.

It is advisable to go for a loan under lower interest rate. Because if the loan interest rate is higher than the company's return on investment, then it will cause liquidity problems in the future.

Bank Overdraft facility

This is subject to higher interest rate and recommended only for a limited time period.

Issuing share to the public

Ordinary shares less cost to the organisation but more power has been given to them. But preference share has less controls over the company but subject to a higher cost to the organisation since they have to pay pre-determined dividends on time.

Franchise option.

This is recommended to expand the business chain with an association with medium scale merchants to promote company's products and goodwill.

Hire purchase schemes

This also important to manage the cash flow situations of the organisation without investing higher capital for equipments & plants.

Lease Schemes

This also important if the company have not greater funds to invest for their assets. But this is subject to higher interest cost.

Credit purchases

This is important to manage the working capital position of the organisation . Since agreement with many suppliers can be obtained credit period to pay the cost of goods purchased.

Debt Factoring

This important to get the cash in early by giving commission chargers to the factoring company to collect their debts very quickly.

Sponsorship

This is ideal by collecting funds from other organisations and giving chance to promote their names.

As per the Banjerjee (2010, pp. 47-58) following funding options also to be considerable.

Debenture issue to investors

Right issues to shareholders

Business Amalgamation

Mortgages

Venture capital strategies to expand the operations.

01. 2 Methods of generating income and contribution to business & service operations.

According to the Hayes & Miller (2011, pp. 5-20) generating income and contribution to the hospitality industry can be identified in following way.

Sales

In the case of hospitality industry is concerned such as hotels, are providing rooms, foods, beverages and other supportive services in order to generate income from that.

Commission.

This commission income will be received from the third party supplier to the organisation.

Sponsorship

This will be received from other organisations to promote their names.

Grants

Grants are receiving from the government , any other authority.

Sub - letting

This can be generated by sub letting the premises to external parties, such as fancy item shops , flower shops , jeweler shops, etc.

Task – 02.

02. 1 Elements of costs, gross profit and selling prices for products & services.

Element of Costs

According to the Davis & Davis (2012, pp. 25-34), followings can be identified as the elements of cost in the hospitality industry.

Materials

Material cost is the cost component in the final product or services which incurred mainly to provide particular products and services.

Eg : Linen , Cutlery, Glassware , China , Silverware,

Consumables

Consumables are the main cost component in the final products in the hospitality industry. This requires further processing to deliver the final product to the customers.

Eg : Foods and Beverages

Labour

Labour cost is the cost which are incurred for the main operating functions of providing final product or services of the organisation.

Eg : Salary paid to waiters, kitchen staff & front office staff

Overheads

Overheads are costs which incurred for indirect materials , indirect labour and other indirect cost. These costs cannot be identified specifically with the final product or service.

Eg : Salary of admin department, electricity, stationery

Selling Price and Gross Profit Margin

According to the Kotas R. (1999 , pp 99-107) pricing methods used by the hospitality industry can be identified as follows.

Pricing in Tourism (Peak / Peak off - trading price)

Selling price on peak seasons prepared by adding a higher markup to the operational cost as selling price. While in peak off seasons it is adjusting by reducing mark up and offering discounts for the selling price while concerning the competition in the market.

Conventional Pricing Method. (Rate of return pricing)

Here, it is emphasised that setting separate contribution margins to the different revenue segments (such as foods, beverages, room, other operational segments). After that it has to select the profit maximising contribution rate. Finally, the selling price will be based on the selected profit maximising sales mix. Gross Profit will be computed by deducting cost of sales from sales.

Absorption Pricing Method

Here, variable cost per unit has to be computed first and after that overhead cost to be absorbed to the unit cost. Finally markup to be added to the total cost to set as the selling price in order to gain required profit.

Contribution Pricing Method. (Marginal Costing)

It is required to categorise the cost as variable & fixed. Then the variable cost per unit has to be computed and based on the variable cost per unit, required contribution to be decided to arrive selling price. There is no absorption of overheads and fixed cost to the unit cost of the product. The Gross profit margin will compute after deducting the variable cost of the sales.

Backward Pricing Method.

This is a method of adjusting the operating cost to a fixed rate. In this case local or national trade organisations has decided fixed selling price and other members have to be accepted this price . Once they need to change this rate, meet again and decide the new price.

Product and Service Costing.

Selling price decided by adding a predetermined percentage of service charge to the unit cost, after adding the profit mark up to the unit cost.

02. 2 Methods of controlling stocks and cash in a business & services environment.

Stock Controls

Proper stock controlling is the way to smooth functioning of daily operations & working capital management in an organisation. According to the Ryan B. (2004, pp: 355-361) following inventory controls are recommended.

Compute economic order quantity level and re - order level of the inventory.

Required to avoid the unnecessary stock purchases .

Create Just in Time inventory management system.

Hospitality industry, mostly dealt with the perishable goods (foods & beverages). Therefore it is ideal to maintain a JIT inventory system to eliminate the wastages, losses, and inventory handling cost.

Implementation of ERP software programme for the inventory management.

This ensures the updated & accurate information linkage within the organisation to take proper inventory related decision on time.

In other hand Warren et al (2008, pp: 270 - 271) emphasise important two controls over inventories.

Safeguarding the stock from damage and theft.

By restricting the store area only to authorised staff members, and it encourages to lock the high value items in a locker while usage of a camera system and security.

Reporting the stocks in the financial statements.

It is required to conduct a physical stock count at the year end and take the figures into accounts, while identifying any mismatch between system & physical figures.

Cash Controls

Holding considerable cash amount is encouraged to conduct smooth functioning of working capital management. According to the Needles and Powers (2011, pp: 399 - 403) there should be following controls over the cash.

Implementation of dual control over the cash.

It is important to give authorisation for two persons to verify & handle the cash balances to eliminate the cash thefts or manipulations.

Preparation of bank reconciliations.

Required to identify the reasons for the differences in cash book figure with bank statement balance.

Conduct a physical cash count in random basis.

This will help to minimise the misconduct by the staff who has handled the cash.

Task – 03.

03. 1 Final accounts analysis of Valentina Hotel Ltd.

03. 1. 1 Source and structure of the trial balance.

Sources of the trial balance are concerned, Kotas and Conlan (2007, pp. 101-115) it has been categorised under three ledgers , namely general ledger, sales ledger and the purchase ledger. Purchased ledger consists the personal accounts of suppliers (Creditors). Sales ledger relates to personal accounts of customers (Debtors). While general ledger consists impersonal accounts. Such as nominal accounts and real accounts. Nominal accounts refer to income and expense accounts. While real accounts refer to the assets and equity accounts.

The structure of the trial balance is concerned , Jagels (2007, pp. 20-21) it has been categorised under the following way.

Current Assets Fixed Assets & Contra Assets

Current Liability Long Term Liability

Owner's Capital Contra Capital

Contra Revenue Revenue

Expenses

Therefore the trial balance consists of accounts which having debit & credit balances and which all of them are summed up at the end.

The trial balance of Valentina Hotel Ltd can be summarised as follows.

Current Assets – Bank / Cash / Debtors

Fixed Assets & Contra Assets – Building / Equipment / Acc. Depreciation

Current Liability – Creditors

Long Term Liability – Long term bank loan / Debentures

Owner's Capital – Ordinary share capital / Retained Profit

Contra Revenue – Opening Stock

Revenue – Sales

Expenses – Salaries / Loan interest / Marketing / Energy / Communication /
Rates & Insurance / Purchases

03. 1. 2 Evaluation of final accounts

03. 1. 2. 1 Income Statement.

Income Statement of Valentina Hotel Ltd for the year ended 28th February
2010.

£ ' 000 £'000

Sales 2, 040

Less: Cost of Sales

Inventory (01/03/2009) 49

Purchases 1, 360

1, 409

Less: Inventory (28/02/2010) (51) (1, 358)

Gross Profit 682

Admin & Operating Expenses

Business rates & insurance (67 – 3) 64

Wages & salary (262 + 5) 267

Depreciation (250 * 25%) 62. 5

Communication expenses 36

Energy Cost 49 (478. 5)

Selling & Distribution Expenses

Marketing 79 (79)

Finance Expenses

Debenture interest (200 *6%) 12

Loan interest 4 (16)

Profit Before Taxation (PBT) 108. 5

Less: Income Tax (39)

Profit After Taxation (PAT) 69. 5

Less: Dividend declared (100*0.15) (15)

Retain profit for the period 54.5

03. 1. 2. 1 Balance Sheet.

Position Statement of Valentina Hotel Ltd as at 28th February 2010.

Assets £ ' 000 £ ' 000 £'000

Non Current Assets Cost Acc. Dep. NBV

Buildings 400 – 400

Equipments 250 112.5 137.5

650 112.5 537.5

Current Assets

Inventory (28 / 02 / 2010) 51

Debtors 92

Pre -paid Insurance 3

Bank 3

Cash 1 150

Total Assets 687.5

Equity & Liability

Equity & Reserve

Stated Capital (£1 Ordinary shares) 100

Reserves – Retained Earnings (157 + 54. 5) 211. 5 311. 5

Non Current Liabilities

6% Debentures 200

Long Term Bank Loans 60 260

Current Liability

Creditors 45

Wages & salary payable 5

Debenture interest payable 12

Income tax payable 39

Dividend payable 15 116

Total Equity & Liabilities 687. 5

03. 2 Budget and variance analysis of Valentina Hotel Ltd.

03. 2. 1 Process and purpose of budgetary controls.

According to the Needles et al (2010, pp. 966) budgetary control is the use of a comprehensive system of budgeting to aid the management in carrying out its function such as planning , coordination and controls.

Purpose of Budgetary Controls.

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The purpose of budgetary controls can be recognised, according to the Kotas R. (1999, pp. 177-180) in following manner.

Achieving business targets. Delegating responsibilities to the staff.

Optimum resource utilisation. To take corrective actions.

Well coordination of work. As a basis of future policy

Use as a basis of performance measurement

Process of Budgetary Controls

According to the Needles et al (2010, pp. 966-969) budgetary control process can be identified as follows.

Period of Budget.

This may be one year or sometimes it can be continuous from previous time to next time.

Approach of Budget.

Selecting a suitable method to use a budget. Such as zero based budgeting .

Implementation of Budget.

Implementation should be done after preparing & approving the budget for the period.

Performance Measurement.

Measure the actual performance with budget during the budgetary period.

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Identification of differences in actual with budgeted performance.

By conducting a variance analysis.

Take corrective action.

Corrective procedures required to produce the performances which are closer to the budgeted performance.

03. 2. 2 Variance analysis.

Computation of RM Variances

Raw Material Total Variance = Standard Cost - Actual Cost

$$= (10,000 * \$ 10) - \$ 98,600$$

$$= \$ 1,400 \text{ F / +}$$

Raw Material Price Variance = Qty. Used (Standard Price - Actual Price)

$$= (11,700 * \$ 10) - \$ 98,600$$

$$= \$ 18,400 \text{ F / +}$$

Raw Material Usage Variance = Std. Price (Standard Usage - Actual Usage)

$$= \$ 10 ((10 * 1,000) - 11,700)$$

$$= \$ 17,000 \text{ (A) / -}$$

Analysis of variances

It has shown \$ 1, 400 favourable total raw material variance from the budgeted figures. It indicates that actual material cost is less than the budgeted material cost and it is in the, within the controls. Further there is a \$ 18, 400 favourable raw material price variance from the budgeted figures. This indicates that the actual price is less than the budgeted price. However it has \$ 17, 000 adverse raw material usage variance from the budgeted figures. This means, RM usage are in out of the controls.

Suggestions for appropriate future management actions

- Take corrective actions to eliminate the over usage of RM.
- Setting new procedures to reduce the wastage of RM.
- Implement new controls to monitor the RM usages.
- Check whether such variance is controllable or not. If it is controllable, then corrective action to be taken. If not a revision of standards is recommended.

Task – 04.

04. 1 Ratio analysis of Audalucia Hotel.

Profitability Ratio

Gross Profit Ratio of the company has been declined by 15. 14% (Appendix – A) compared to the 18. 33 % of this year with 21. 60 % of last year. Net Profit Ratio also declined by 30. 56% (Appendix – A) compared to the 3. 59 % of this year with 5. 17 % of last year. Apart from that Return On Capital Employed (ROCE) also decreased by 31. 73% (Appendix – A) compared to the 8. 24 % of this year with 12. 07 % of last year. This incurred due to increase in expenses & cost of sales.

Liquidity Ratios

Current Ratio of the company has been increased by 0.52 times (Appendix – A) compared to the 3.68 : 1 of this year with 3.16 : 1 of last year. Quick Ratio decreased by 0.50 times (Appendix – A) comparisons to the 2.43 : 1 of this year with 2.93 : 1 of last year. This incurred due to over fund usage on closing stock.

Efficiency Ratios

Inventory Turnover Ratio of the company has been decreased by 36.25 times (Appendix – A) compared to the 17.37 times of this year with 53.62 times of last year. Inventory Turnover Period has been increased by 14 days (Appendix – A) compared to the 21 days of this year with 7 days of last year. Debtors Turnover Period has been decreased by 7 days (Appendix – A) compared to the 39 days of this year with 46 days of last year. Creditors Turnover Period has been decreased by 5 days (Appendix – A) compared to the 25 days of this year with 30 days of last year. This incurred due to over fund utilisation on stock, increase of debtors & creditors.

Investors / Financial Ratios

Earnings Per Share (EPS) of the company has been decreased by £ 0.21 (Appendix – A) compared to £ 0.25 of this year with £ 0.46 of last year. This has incurred due to low profit earned during the period and new share issue.

04. 2 Appropriate future management strategies for business and service operation.

Following strategies to be taken by the management to eliminate the discrepancies identified in the ratio analysis.

Reducing the selling price & volume of sale should be increased to gain higher revenue.

Unnecessary fund utilisation on the stock should be reduced. The JIT stock system to be implemented to minimise the stock handling cost.

Take necessary steps to reduce the expenses in regularly.

Negotiate with suppliers to obtain longer credit period while asking lower credit period to the customers.

Follow proper cash flow management procedure within the organisation.

Implement new procedures to attract the customers to the company to increase the sales while conducting discounts & promotions.

Non Current Asset should have used in very efficient & effective manner to generate income from it.

Task – 05.

05. 1 Categorisation of costs of Leicester Square Hotel.

Fixed Cost

As per the Horngren et al (2009, pp: 28-29) fixed cost is the cost which remained unchanged in total for a given period regardless of changes in volume or activity.

Eg :

Fixed Cost of the hotel operation – £ 1, 600, 000

Variable Cost

According to the Drury (2008, pp. 32-34) variable cost is the cost which changes in direct proportion to the volume of the activity.

Eg :

VC of Food sales per room – £ 7

VC of Beverage sales per room – £ 2. 4

Semi Variable Cost

According to the Kinney & Raiborn (2011, pp. 28-29) semi- variable cost is the cost which consists both fixed and variable components for a given activity. It remains as fixed up to a certain level and beyond that it will be variable based on the volume or activity.

Eg :

Variable Cost per occupied room – £ 15

VC of Minor operations departments per room – £ 1. 2

05. 2 Cost / Profit / Volume analysis of Leicester Square Hotel.

Computation of Contribution per product / customer (in £)

Description Room Foods Beverages Minor Dept. Total

Selling Price 120 20 8 2 150

Variable Cost (Appendix – B) (15) (7) (2. 4) (1. 2) (25. 6)

Contribution 105 13 5. 6 0. 8 124. 4

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(Per product/customer)

Net Profit Computation (in £)

Sales (150 * 100 * 365) = 5, 475, 000

Less : Variable Cost (25. 6 * 100 * 365) = (943, 400)

Contribution (124. 4 *100* 365) = 4, 540, 600

Less : Fixed Cost = (1, 600, 000)

Net Profit = 2, 940, 600

Break Even Point Computation

BEP (in units) = Fixed Cost

Contribution per customer

= 1, 600, 000

124. 4

= 12, 861. 74

↑© 12, 862 (Customers)

BEP (in £) = BEP (in units) * Selling Price

= 12, 862 * 150

= 1, 929, 300

Cost -Volume -Profit Relationship

Value

(£ ‘ 000)

TR Total Revenue (£ 5, 475)

(£5, 475)

Profit (£ 2, 940. 6)

Profit

BEP BEP

(£1, 929) VC (£ 934. 4)

Loss FC (£ 1, 600)

(Customers)

0 BEP (12, 862) (36, 500)

According to the Blocher et al (2006, pp 238-241) Cost-Volume -Profit analysis is the method of analysing how operating decision and marketing decision affects the net income based on the relationship between cost (VC & FC), volume (output level) and selling price.

The hotel is required to sell 12, 862 rooms to the customers to achieve breakeven point of sales. According to the Hansen et al (2009, pp. 591-595) Breakeven point is the level at which revenue is equal to the total cost and the profit is zero. Since they can obtain £ 1, 929, 300 revenue to cover the total cost and beyond that they can earn profit from every additional

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customers. If the hotel unable to achieve 12, 862 customers per annum, they have to suffer with losses. The Hotel can earn contribution of £ 124. 4 from every customer and if they achieve the expected sales level of 36, 500 customers , they can achieve £ 2, 940, 600 profit for the period.

05. 3 Justification of short term management decisions based on CPV analysis.

Margin of Safety (in units) = Expected Customers - BEP Customers

$$= (365 * 100) - 12, 862$$

$$= 36, 500 - 12, 862$$

$$= 23, 638$$

Margin of Safety (in £) = Margin of Safety (in units) * SP

$$= 23, 638 * 150$$

$$= 3, 545, 700$$

Degree of Operating Leverage = Contribution Margin

Net Profit

$$= 4, 540, 600$$

$$2, 940, 600$$

$$= 1. 54 (low risk)$$

According to the Blocher et al (2006, pp 249-252) margin of safety is the amount or units of sale above the sales. In that case hotel can generate £ 3, 545, 700 turnover by 23, 638 customers. It indicates that this hotel investment is worth.

As per the Hansen et al (2009, pp. 597-598) degree of operating leverage is the ratio of contribution to the profitability. In this case, it shows a lower leverage of 1. 54 since it generates lower risk to the future profitability of the hotel. Therefore it is justifiable that management has been taken an optimized and a worth decision regarding this investment.

Conclusion.

According to the given cases of this assignment is concerned it is clear that practical application of theories in hospitality management is really essential in order to obtain proper decisions to improve the profitability, avoid control deficiencies and smooth functioning of routine operation of the business.

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