STARTING A RESTAURANT: DO WE COOK OR CALCULATE FIRST?

Robert McDonald
University of New Haven

Vin DeOrio was gratified that his 23 year old nephew offered to set up back office systems for Vin's new business. But Vin was worried that his nephew, a newly minted BS in accounting, was inexperienced in installing such systems, and that the nephew would design an overly elaborate system for a simple business. It was several months since Vin was fired after twenty years as a product manager at Stearnco, an industrial goods manufacturer. Vin thought this was an opportunity to finally do what he always wanted to do - run his own restaurant. His plan was to have two sides to the restaurant, on one side a bar serving sliders, hotdogs, and pizza, and on the other side, an upscale restaurant.

His nephew outlined the efficiencies and effectiveness of job shop costing, process costing, standard costing, target costing, and life-cycle costing. The case will allow a review of the data needs and outputs of each costing approach and match Vin's cost management needs to each of these systems.

"Brian, I have to decide on a location, matching drape colors with furniture, select the menus, hire staff, all for an opening six months in the future. I really don't think I have time to play CPA. I don't want to spend a lot of time on choosing accounting systems, of which I know nothing. Our future success depends much more on décor and menus rather than how many journal entries we make. Maybe we don't need a cost accounting system or budget for this small scale of operations. Maybe I only need my CPA to give me the four monthly financial statements and I can gauge success from those."
"Uncle Vin, I think you are spending way too much time on the calorie charts and color swatches. We have to get involved with our costing and budgeting system, so we have it up and running when you open your restaurant."
Vin DeOrio started to regret letting his nephew, Brian, get involved with his accounting system for his new venture as a restaurateur.

OUT OF WORK

Vin had not fully adjusted to his new state of being out of work. During his twenty years at Stearnco, he worked his way up to product manager for a group of industrial products. That position provided a good living for his family and some sense of accomplishment for Vin. But when his boss, the VP of Marketing, hesitantly called him into his office, Vin was not too surprised that his position was

being eliminated. Rumors were floating around about the board's need to reduce costs to improve profits, and competitors had already started rounds of cutbacks of mid- level managers. Vin's salary and bonus averaged $150,000 for the past five years, and he had been able to save his goal of 8% of his gross salary, while at the same time Stearnco had funded a separate retirement account. Vin felt that for his age he had adequately saved and accumulated generous pension rights. He was 44 years old, and he believed this change in his career allowed one last chance for his dream for his own restaurant. He had savings and IRA accounts of close to $400,000. In a pinch he could count on borrowing $100,000 from family members. This gave him $500,000 for an equity investment, with several hundred thousand dollars in additional borrowing capacity.

Vin found the building he wanted for his restaurant in an area close to several strip malls and small office buildings. He hoped to attract shoppers from the malls and to cater functions in the office buildings. It was a triangle shaped building containing a recently closed restaurant at street level. A large wall split the triangle shape with dining rooms on either side of the wall. The room with the smaller seating capacity also had the bar which had no seats but space for waiters to order and pick up drinks. Vin's plan was to expand the bar area with stools and booths and serve a simple menu of pizza, sliders, and sandwiches. The other dining room would be an upscale restaurant with white linen tablecloths and fine food.

Vin was excited about his new business prospects. Since high school, he had an interest in cooking. He picked up as much as he could from his mother. Later in college, Vin was the chef when the dorm students needed some late snacks or on weekends when the food service had an early closing. Now Vin was arranging menus in his mind from favorite meals and favorite restaurants. While Vin was dreaming about the exciting prospects in food, his nephew, Brian, was forcing him back to reality with the need to plan ahead in this new venture through the use of budgets and financial standards. Brian stressed the preparation stage and the need to keep financial controls in place to insure success in this new venture. Brian was sure that the high failure rate of new businesses was due to the lack of financial knowledge and corresponding financial controls. Brian did not want Vin to spend all his time on color arrangements and calorie charts.

While at Stearnco for his twenty year career, Vin did come in contact with many controllers and assistant controllers. He was able to extract valuable information from the accounting system that Stearnco was continually expanding and improving. He was familiar with standard costing in the successful product lines, but Stearnco was a manufacturer of metal products, not a restaurant catering to whims and changing tastes of its customers. He was not sure how to transfer Stearnco's accounting system to a restaurant new venture.

Brian was 23 years old and just graduated with a BS in accounting. He had several accounting instructors with backgrounds in industry and from them Brian chose private accounting rather than public accounting. He was looking for an entry spot in the controller's department for a large industrial corporation. To prepare him for his corporate accounting career, Brian was able to take three managerial accounting courses for his BS. He was eagerly laying out accounting choices for Vin: detailed budgeting, and various cost systems, such

as standard costing, job shop costing, process costing, life cycle costing, and target costing. A small conflict was building between Vin and Brian. Vin was more interested in menus and less on accounting, while Brian focused on accounting and little interest in food. Vin understood food but not accounting, while Brian was focused on accounting and less so on food.

THE GRAND DINNER

Vin remembered his father talking about a famous hunters' dinner, the Grand Dinner, that was held in Ohio during the 1960s. The dinner's menu included seven meats, deer, bear, elk, moose, buffalo, rabbit, and duck along with potatoes and vegetables. The beer and wine service was adequate, but the main interest was the meat choices. The sponsor of the dinner was a wealthy industrialist who happened to be an avid hunter with many hunter friends. The attendees paid a fee, but that fee did not cover the added cost of the unusual meats. Vin thought about a Grand Dinner held twice a year with an expensive and broad menu, but in this case, the wine and beer would be extravagant. Vin was not planning on subsidizing the dinner, and in the beginning would hope to cover all costs. Later after he had gained experience with the Grand Dinner he would plan on making a profit from it.

Vin was concerned that his restaurant would take longer to attract a loyal clientele, and during this time he would stretch his resources to a breaking point. While in the start-up phase for the two dining rooms, Vin was considering a catering service for corporate events in the businesses located in the several small office buildings nearby. He would personally visit the larger firms to offer a lunch and party service that would meet the firms' needs. He thought he could make a small profit on this line of business and it would fill in during his slower times in the early development stage of the restaurant. After his two restaurants became profitable, he planned to reduce the catering service and concentrate on the two restaurants and the Dinner.

BRIAN'S ACCOUNTING NOTES

Brian had to turn to his class notes on the types of cost accounting systems. He selected: standard costing, job shop costing, process costing, life cycle costing, and target costing. He grilled Vin on the restaurant operations to try to map the various cost systems to Vin's restaurant. Vin's dream was to have a well-stocked bar with stools and booths along with a casual restaurant. Next to the casual restaurant would be an upscale restaurant with white linen tablecloths and fine food. Vin also talked about his semi-annual Grand Dinner along the lines of the hunters' dinner he had heard about in his youth.

Standard Costing

Standard Costing uses a pre-determined cost of direct material, direct labor, and overhead. Standard costing assumes you have been manufacturing this item for a long time and you have considerable experience in making the product. This cost is calculated before the actual year begins, such as in November for the next calendar year. As the year progresses, the actual costs of material, labor, and overhead are compared to the pre-determined standards

and variances are calculated by subtracting the standard from the actual amounts. The variances are reported to the responsible managers, whose job it is to analyze the variance to see if the variance will continue and what actions are required to get back on the standard. Brian would have to acquire standards for the two proposed menus in the two dining rooms, and he thought he could find some material from established and publically traded firms, such as Darden Restaurants and Cheesecake Factory. Both of these public firms were known to have strong financial bases for their operations. A second source for Brian would be trade associations for the food service industry. A third possibility would be to hire a consultant from the local college with a hospitality degree.

Job Shop Costing

Job Shop Costing tries to record the actual direct material and direct labor for a project. The overhead is estimated through the use of an overhead rate and allocations. Job shop tries to record the actual material and labor because it assumes you are doing different projects continually or completing something to a specific contract and not for standing inventory. So you need specific material and labor costs for individual projects. Brian would have to determine how to record the actual material and labor by dining room, by shift, by day, or by week. Considerable effort would go into recording the actual data; then you would have to know what to do with the actual data, how to interpret it and improve from it.

A key aspect of job costing is the preparation of a job card. It contains in one place the customer name, specific demands of the customer, the actual direct material, actual direct labor, estimated overhead and estimated revenue. These job cards serve as a valuable marketing tool in addition to being an important document for job costing. After reviewing the job card description of specific goods and services ordered by the customer matched with specific costs, Vin can see on which jobs he is making money and on which jobs he is losing money. After he has this information, he reduces or eliminates the losing jobs and specializes in the profitable jobs. Vin remembered from his Stearnco days that 80% of the sales and 80% of the profit were generated from 20% of the customers and 20% of the transactions. He knew he had to find that 20% quickly.

Process Costing

Process Costing is the opposite of job shop costing in that it assumes you are doing the same actions over and over. Since you are doing the same actions over and over, there is no need to record the actual material and labor for a specific room, shift, or day. Process costing would not require the data handling effort that job shop costing would. Typical process costing installations, such as a steel mill or refinery, operate around the clock and are always processing something. Because of this continuous processing, there is work in process at the beginning and at the end of the period. One challenge in process costing is to equate production with the changes in the opening and ending work in process inventory accounts to arrive at equivalent unit production for the period. Vin's operation would not go all day and should not have opening and ending work in process inventory amounts, so his application is simpler than many process costing installations.

Life Cycle Costing

Life Cycle Costing accumulates the cost of a project over a period of years from the origination of the idea for a marketable product, to the research of the project, its development, preparation for volume production, marketing and sales efforts, and post-sale customer service. This accumulation could cover a period of years and the accumulation is held in an asset account. Since this cost system accumulates the origination and development of an idea as an asset subsequently to be amortized over time, it can violate GAAP, which requires the expensing of the early research and development. Life cycle costing tries to show the full, accumulated cost of a project and track the product through its economic life cycle, that is, growth, maturation, decline, and termination. Life cycle costing is appropriate when the developmental period is long, or where large costs are incurred prior to costs incurred during high volume production runs for actual customer sales. Life cycle costing does not segregate costs into neat calendar periods such as quarters and years. Under financial accounting those calendar periods are followed closely and production costs are highlighted, with the earlier research and development costs having been written off. With the early research and design efforts and costs emphasized, life cycle costing can set sufficiently high prices to cover the early research and design amounts, in addition to the production and customer service costs long after the research and development stage.

Target Costing

Target Costing reverses the typical sequence of pricing a product after the cost has been determined. In most cost systems, costs are accumulated first and then some formula is used to set the selling price, for example, price is set at two times cost. This pricing must allow a generous gross profit (selling price less cost of product) which can absorb the selling and administrative expenses and leave an adequate operating profit. In contrast, target costing first estimates the selling price that a typical customer would pay for the product with the perceived benefits to the customer. The accountant then subtracts a necessary profit as a percentage of sales or a return on investment for the product. Selling and administrative costs are estimated and subtracted from that target price, and the remaining number is the residual or target cost. Actual costs are estimated and compared to this target cost, and frequently the actual cost is greater than the target cost. Value engineering, made up of participants from design, engineering, production, and purchasing, attempts to cut the actual cost down to the target cost. The value engineering will focus efforts on both value added and non-value added costs.

Target costing emphasizes how much the customer is willing and able to pay for a good or service. The producer of the good must know the components of perceived satisfaction on the part of the customer, and how much each part is valued by the customer. Value engineering can then whittle down unnecessary aspects of the product and at the same time reduce or eliminate non-valued added costs.

Brian now had to make a recommendation. His was excited that his uncle Vin had asked his opinion about such a life changing event and he wanted to make sure that he considered all viable alternatives, but which one should he recommend?