Indicators of Restaurant Success

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Indicators of Restaurant Success

By Dallin Williams

Opening a restaurant may be the product of a lifetime of education and work. A chef may devote himself to his practice and be able to produce outstanding food. The result of this dedication may be remarkable, but all of these factors may be in vain if the restaurant is not built on good business practices. Through comparing different studies researchers have found that the failure rate of restaurants in the first four years was consistently 67%1 (see Figure 1). In order to ensure the success of their business, restaurant owners must take into account three key business attributes: 1) profitability, 2) liquidity, and 3) solvency.2

Profitability

Any business can improve profitability in one of two ways: 1) increasing revenue or 2) decreasing expenses. Profits can be measured through the return on sales ratio and the gross profit ratio (see Figure 2).

A restaurant can increase revenue by enticing more people to eat its food. Retaining customers is most efficient. According to researchers "83% of customers will not return to a restaurant if they have experienced poor service."3 Regarding customer satisfaction, experts explain, "food quality is a critical attribute influencing customers decisions to return to a restaurant, followed by quality of service, cost or value of the meal and place or ambience of the restaurant."4 If a restaurant owner can improve these aspects of their operations, revenues will likely increase.

An essential element in improving gross margin is menu pricing. Managers are encouraged to "have a
clear view of operating costs and not just food cost, so as to ensure that menu prices rationally reflect all elements of operating costs. If ever fluctuating overhead costs are not incorporated into the pricing of food, restaurants will not make enough money to cover expenses. When changing prices, chefs can reduce portion sizes and simultaneously creatively present the food in order to “retain the value proposition in the eyes of the customer.”

Reducing expenses is more complicated than increasing revenues. A restaurant has numerous expenses that vary tremendously. Restaurant owners should examine these expenses to eliminate any waste, fraud, or errors. For example, statistics show that restaurants on average lose 4-5% of their sales to employee fraud and theft. This expense can be reduced by implementing a system that monitors employees and penalizes them for theft. Other expenses can be addressed through a similar process of awareness and action.

**Liquidity**

In order for a restaurant to survive it must be fairly liquid, meaning it has the cash or cash-equivalent assets necessary to pay for their variable day-to-day costs. A business can know it is liquid through a number of analyzing tools. The two most common are the current ratio and the quick ratio (See Figure 2.) As these ratios increase, “the less likely [it is] that the firm will need to seek external funding sources to cover current liabilities.”

A slightly more complicated but highly useful liquidity analysis tool is the cash conversion cycle measure. This computation is effective because it shows how long a company is without cash. The lower the number the better, since it implies that a company has less time devoted to eliminating payables and can use that cash to pay expenses.

**Solvency**

Solvency is similar to liquidity but shifted from short-term to long-term. A solvent restaurant owns assets with a total value greater than their total debt. By using solvency ratios an “investor can gain insight into how likely a company will be to continue meeting its debt obligations.” A more solvent restaurant is less likely to have to sell or lose their most needed assets, giving them a greater chance of survival in hard times.

A couple of ratios used to measure solvency are times interest earned and the solvency ratio (see Figure 2). These ratios calculate how much of a company’s profits can be contributed towards paying interest, which gauges how effectively a business can control its long-term debt.

**Conclusion**

In the business of restaurants, passion for the industry, dedication to the work, and talent in the field are important, but are not enough. Restaurant owners must practice good management and recognize when his or her business is in trouble financially. In Figure 2, all the financial ratios discussed in this article are laid out, with their formulas and industry averages. These ratios should be checked periodically, and if the analyst finds that these ratios are far from the industry average in the wrong direction, action should be taken.

When opening a restaurant, owners have the odds against them. However, with the right knowledge and careful observation, any business owner can turn the tables and greatly improve their chances for success.

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**Notes**


**Figure 2: Financial Ratios**

<table>
<thead>
<tr>
<th>Ratio Name</th>
<th>Formula</th>
<th>Desire</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquidity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Ratio</td>
<td>Current Assets-Current Liabilities/Current Liabilities</td>
<td>High</td>
<td>0.841</td>
</tr>
<tr>
<td>Quick Ratio</td>
<td>Current Assets-Current Liabilities/Current Liabilities</td>
<td>High</td>
<td>0.481</td>
</tr>
<tr>
<td>Cash Conversion Cycle</td>
<td>See Figure 3</td>
<td>Low</td>
<td>0.584</td>
</tr>
<tr>
<td>Solvency</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest Coverage</td>
<td>Earnings Before Interest and Tax/Interest Expense</td>
<td>High</td>
<td>10.662</td>
</tr>
<tr>
<td>Solvency Ratio</td>
<td>Net Income – Depreciation-Long-Term Liabilities</td>
<td>High</td>
<td>0.2</td>
</tr>
</tbody>
</table>

**Figure 3: Cash Conversion Cycle**

\[
\text{Cash Conversion Cycle} = \text{Days in Accounts Receivable} + \text{Days in Inventory} - \text{Days in Accounts Payable}
\]

\[
\begin{align*}
\text{Days in Accounts Receivable} & = \frac{\text{Average Accounts Receivable}}{\text{Revenue Sold}} - \text{Average Account Receivable} \\
\text{Days in Inventory} & = \frac{\text{Average Inventory}}{\text{Cost of Goods Sold}} - \text{Average Inventory} \\
\text{Days in Accounts Payable} & = \frac{\text{Purchases}}{\text{Average Account Payable}} - \text{Average Account Payable}
\end{align*}
\]