Indicators of Restaurant Success

RESTAURANT OWNER

Photo courtesy of the author

By Dallin Williams

Opening a restaurant may be 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. Dr. Frazer of Walden University researched the success rate of local restaurants. Through comparing different studies, Dr. Frazer found that the failure rate of restaurants was consistently 67% in the first four years[1] (see Figure 1).

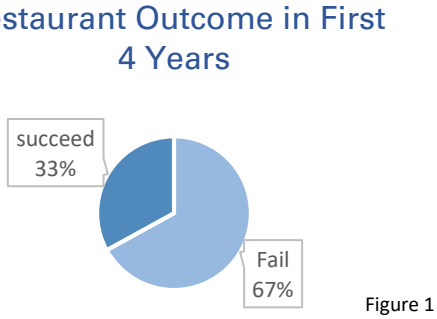

Figure 1

Data source: Frazer, Linval George. "The Effect of Internal Control on the Operating Activities of Small Restaurants."

Dr. Frazer explains three key business attributes that restaurants must take into account in order to ensure the success of their business: 1) profitability, 2) liquidity, and 3) solvency.[2]

These attributes will be described as well as how they can be measured through accounting ratios. By tracking these ratios, restaurants can ensure their success by maintaining the ratios at safe levels; doing so will help restaurants identify and solve problems as they arise.

Profitability

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

As for earning more revenue, a restaurant does so by enticing more people to eat its food. Restaurants can market new customers in many fashions, but retaining customers is more efficient. In order for a customer to eat again at a restaurant, he or she must have a pleasurable experience. According to Dr. Frazer “83% of customers will not return to a restaurant if they have experienced poor service.”[3] Regarding customer satisfaction, writers Munjal and

Financial Ratios

Ratio Name	Formula	Desire	Average
Profitability			
Return on Sales	Net Income/Revenue	High	0.255
Profit Margin	Gross Profit/Revenue	High	0.455
Liquidity			
Current Ratio	Current Assets/Current Liabilities	High	0.825
Quick Ratio	Current Assets-Inventory/Current Liabilities	High	0.467
Cash Coversion Cycle	See Figure 3	Low	-2.764
Solvency			
Interest Coverage	Earnings Before Interest and Tax/Interest Expense	High	10.662
Solvency Ratio	Net Income+Depreciation/Long-Term Liabilities	High	0.2

Figure 2

Data source: Canina, Linda, and Steven A. Carvel. "Short-Term Liquidity Measures for Restaurant Firms: Static Measures Don 't Tell the Full Story." *Cornell Hospitality Report.* 7, no. 11 (August 2007): 6-15.
Credit Guru Inc. "Industry Norms and Key Business Ratios." Accessed October 25, 2017. http://www.creditguru.com/index.php/financial-analysis/financial-statement-ratio-analysis/107-industry-norms-and-key-business-ratios
CSI Market. "Restaurant Industry Financial Strength Information" Accessed October 25, 2017. https://csimarket.com/Industry/industry_Financial_Strength_Ratios.php?ind=914
Fuhrmann, Ryan C. "Analyzing Investments with Solvency Ratios." Accessed October 25, 2017. http://www.investopedia.com/articles/investing/101613/analyzing-investments-solvency-ratios.asp

Sharma have explained, "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 increase.

An important 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."[5] If ever fluctuating overhead costs are not incorporated into the pricing of food, restaurants will not make enough money to cover expenses. Many owners feel that changing the pricing would be a risk, considering that customers may have expectations of an established menu. In these cases, chefs can reduce portion sizes and simultaneously creatively present the food in order to "retain the value proposition in the eyes of the customer."[6]

The more complex element of profit in the food service industry is reducing expenses. A restaurant has countless expenses that vary tremendously. Addressing all the possibilities is near impossible, but Dr. Frazer explains, "In the restaurant business, every error has an effect. Clear, precise standards will help to eliminate inefficiency, fraud, errors, and waste."[7] In other words, strict and orderly management is the best way to eliminate unnecessary expenses.

One example of controlling expenses is explained by Frazer. Statistics show that "that independent restaurants may lose from 4% to 5% of annual sales to fraudulent activities and

theft by employees." Theft like this happens because "employees have discovered how easy [their restaurants] are to perpetrate."[8] This problem can be solved by implementing a system that monitors employees and penalizes them for theft. Though such a system may be unpopular among employees, it is fair and can eliminate a huge, unnecessary cost.

Managers must analyze the possible losses their restaurant is experiencing (since the circumstances will be different for each restaurant) and make managerial changes to eliminate those cost and thus increase profits.

Liquidity

In order for a business to survive day-to-day, it must be liquid. Liquidity is a measure of a business's short-term assets and liabilities. Restaurants must keep a liquid reserve so that they can "meet cash obligations as they come due."[9] If the business does not have enough current assets to meet these expenses, they may need to "delay payments, obtain temporary financing at unfavorable terms, or even sell assets,"[10] all of which can negatively affect a company.

A business can know if it is in good standing in terms of liquidity 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, or in other terms, as a business has more current assets compared to our current liabilities, "the less likely that the firm will need to seek external funding sources to cover current liabilities."[11] If a company sees this ratio start to get lower, the company must make changes in its operational practices.

A slightly more complicated but highly useful liquidity analysis tool is the cash conversion cycle measure. This computation is effective because it transforms many parts of the financial statements into "the amount of time, in days, that it takes the firm to transform cash spent to purchase inventory for sale into cash collected from that sale."[12] In other words, this number tells a company how long a current liability takes to transform into cash, which is the most liquid asset. The cash conversion cycle can be computed as shown in Figure 3.

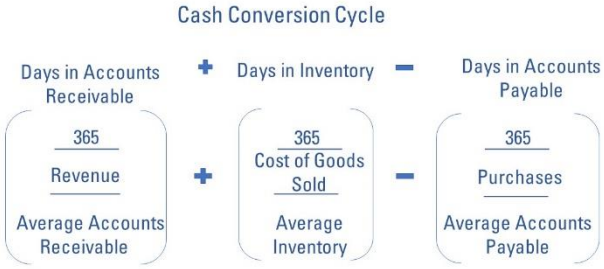

Figure 3

Image courtesy of the author

Basically, the calculation shows how long a company is without cash. So, 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. "Having a negative number implies that the company's operating cycle is short compared to its payables deferral"[13] or that a company gets paid cash for sales before the company must pay for inventory.

Solvency

Solvency is similar to liquidity but shifted from short-term to long-term. By using solvency ratios "an analyst or investor can gain insight into how likely a company will be to continue

meeting its debt obligations"[14] If a company is unable to pay off long-term debts as they arise,

long-term assets such as equipment and buildings can be negatively impacted. In restaurants, every piece of equipment has a vital contribution to food production and customer service. Losing even a small amount of equipment could be detrimental to a restaurant.

A company can measure its solvency through many ratios, but only two simple calculations will be discussed in this article. The first is interest coverage, otherwise known as "times interest earned" (see Figure 2). This ratio calculates how much of a company's profits can be contributed towards paying interest, which gages how effectively a business can control its long-term debt. The solvency ratio (see Figure 2) also interprets how much income is available to pay off long-term liabilities. Solvency may seem like an obscure concept but is easily computable through items found on the balance sheet and income statement.

Conclusion

Just as any other company, restaurants want to keep doing business. 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, which can be easily computed by simply addressing the company's financial statements; this can be done by even the most inexperienced business owner.

In Figure 2 are listed the industry averages for each ratio, and whether a restaurant should prefer to be higher or lower than the stated average. 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. Any manager who is well familiar with the procedures in his or her restaurant should be capable of recognizing where changes can be made; numerous examples have been mentioned here.

When opening a restaurant, owners have the odds against them. With the right knowledge and careful observation, any business owner can turn the tables and take control of the fate of their company.

Notes

1. Linval George Frazer. "The Effect of Internal Control on the Operating Activities of Small Restaurants" (PhD diss., Walden University, 2011), 46, https://search.proquest.com/businesspremium/docview/868328421/50A2E9C361D849B6PQ/4?accountid=4488#.
2. Frazer, “The Effect,” 46-47.
3. Frazer, “The Effect,” 49.
4. Sandeep Munjal and Sanjay Sharma, “Applying Innovative Food Cost Management Practices in Inflationary Times,” *Worldwide Hospitality and Tourism Themes* 4, no. 5 (2012): 466, https://search.proquest.com/docview/1149274476/FBD06011E5AA4BF7PQ/5?accountid=4488.
5. Munjal, “Applying,” 467.
6. Munjal, “Applying,” 470.
7. Frazer, “The Effect,” 48.
8. Frazer, “The Effect,” 50.
9. Linda Canina and Steven A. Carvel, “Short-Term Liquidity Measures for Restaurant Firms: Static Measures Don 't Tell the Full Story,” *Cornell Hospitality Report.* 7, no. 11 (August 2007): 7, http://scholarship.sha.cornell.edu/cgi/viewcontent.cgi?article=1015&context=chrpubs.
10. Canina, “Short-Term,” 7.
11. Canina, “Short-Term,” 8.
12. Canina, “Short-Term,” 11.
13. Canina, “Short-Term,” 14.
14. Ryan C. Fuhrmann, “Analyzing Investments with Solvency Ratios,” Accessed October 25, 2017, http://www.investopedia.com/articles/investing/101613/analyzing-investments-solvency-ratios.asp.