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Illustration by Keith Ibsen

10 Red Flags

Startup Restaurant Financial Warning Signals You Should Not Ignore

By John Nessel

After 20 years in the restaurant industry (15 years as an independent owner/operator and the last five years as a consultant), I have observed just about every type of financial problem imaginable. As all restaurant veterans already know, this business is very unforgiving when it comes to achieving bottom line profits.

Based on the 2004 Restaurant Industry Operations Report published by Deloitte & Touche, LLP, average pretax profit margins range from 4 percent to 7 percent (4 percent for full-service and 7 percent for limited-service restaurants). Not only is there little room for financial management missteps, the problem is compounded by the lack of business experience and basic financial skills that most startup restaurateurs bring to the table. Unlike many other small businesses that employ full- or part-time financial personnel, most restaurant owners cannot afford that luxury, and spend their days jumping from one operational task (or crisis) to another with the financial management of the restaurant not receiving the attention that it requires.

In my role as a consultant I have developed an informal "punch list" of basic financial information that I request from new clients and a review of their basic financial procedures before getting started. This information usually provides me with what I need to assess the financial health, and often the prospects of the business. It does so in part by raising a number of "red flags" or indicators that point to where the problems are and where problems are likely to emerge. It also allows me to put in place a plan so that I can quickly offer the kind of support that will give them the best chance to survive and thrive well into the future.

One thing needs to be made clear at the outset. No amount of consulting support or improved financial skills and procedures can solve a restaurant's financial problems if they result from inadequate sales. Many of your restaurant's fixed expenses cannot be brought into line (as a reasonable percentage of sales, that is) if your gross revenues are too low. Moreover, all of your efforts to maintain an accurate accounting system with well-prepared financial reports, which permit proactive day-to-day management, will be for naught if your revenues are not sufficient for the business to be profitable. Therefore, we will focus on those red flags that hopefully can be corrected by the improved procedures or management of your existing revenues, or at worst, by helping to quantify the additional revenues that will be required.

The combined total of your restaurant's "prime cost" is where the battle for restaurant profitability is truly waged.

Red Flag No. 1: Absence of a Well-Organized and -Operated Accounting System

The first and most important piece of information that I request when evaluating the financial health of a restaurant is a copy of its accounting software file (most typically a QuickBooks backup file). Printed copies of basic financial statements (profit-and-loss and balance sheet) are not adequate for this task because they do not verify the accuracy of the numbers presented. Only by reviewing how all the financial transactions are actually "posted" to the general ledger can I determine the degree of accuracy of the numbers produced. Since you cannot manage what you cannot count, when a restaurant's accounting system is either nonexistent or not properly set up or carried out, it often results in the restaurant owner "flying blind." While I have dealt with a few restaurants that are profitable in spite of having a poorly operated accounting system, my experience is that the degree that the business is being proactively managed is directly correlated to how well the owner is managing his "books." Some of the most common problems that I see include:

- ✓ A chart of accounts that does not reflect industry standards, and whose operating results cannot be compared with others (learn more about the "Uniform System of Accounts for Restaurants" and compare your financial results against industry averages by visiting the National Restaurant Association Web site at www.restaurant.org/research/operations/report.cfm).
- ✓ Improper posting of financial transactions such as cash and credit card receipts recorded as revenues rather than as cash (or another appropriate current asset account on the balance sheet).
- ✓ Labor expenses from the restaurant's payroll report either inaccurately recorded or not broken down in functional categories such as kitchen versus front-of-the-house labor.
- ✓ Confusion about the difference between the restaurant's food and beverage (F&B) *purchases* and F&B *inventory*. (See "Red Flag No. 4" for more detail.) Since all the other red flags discussed in this article cannot be accurately identified or evaluated if the accounting system is not set up and put in place properly, this task should be the restaurant owner's primary concern if he or she desires to create a viable operation. Make sure to have the support of an accountant or restaurant financial consultant before you open to ensure that you give yourself a chance to succeed. If you are already open and suspect that your accounting system is in need of first aid, then do yourself a favor and get some help as soon as possible. As I said earlier, I have rarely seen a financially successful restaurant that did not have its accounting and financial controls in order.

Red Flag No. 2: Key Operating Expenses Too High Relative to Gross Sales

Restaurant food-and-beverage purchases plus labor expenses (wages plus employer-paid taxes and benefits) account for 65-70 cents of every dollar in restaurant sales. The combined total of these two cost categories, referred to as your restaurant's "prime cost," are where the battle for restaurant profitability is truly waged. (Prime cost is the cost of sales plus all payroll costs including gross salaries and wages, and payroll taxes, benefits and insurance.)

This is not simply because they represent the largest percentage of your total expenses, but also because you have the ability to control them. Unlike utility and insurance expenses that are relatively fixed, you can affect your food cost percentage by more effective purchasing, product handling and menu pricing. Similarly, hiring practices, scheduling, and even the layout of your kitchen and the way your menu items are selected can favorably affect labor costs. This is the bottom line: When I see a restaurant's prime cost percentage exceed 70 percent, a red flag is raised. Unless the restaurant can compensate for these higher costs by having, for example, a very favorable rent expense (e.g., less than 4 percent of sales) it is very difficult, and perhaps impossible, to be profitable. While we are on the subject of rent expense, on a national basis a restaurant's occupancy expense (this includes not only rent but also real estate taxes, property insurance and common area charges) is the single highest expense after its "prime cost," and averages around 6 percent of sales. As a fixed expense, the only way that you can reduce this ratio is to increase sales. When I see this number exceeding 8 percent of sales, another red flag is raised. In this case I divide the restaurant's annual occupancy cost by 6 percent to determine the sales level that will be required to keep occupancy expenses in line with industry norms.

Red Flag No. 3: Menu Items Not Accurately Documented, 'Costed' and Updated

The most common method of menu item pricing that I have observed over the years is what I will call the comparative approach. Restaurateurs simply check a few other restaurants that they compete with, find a similar item on their menu, and then price their item accordingly. Now it's one thing to document and cost out all your menu items and then to determine what your selling price will be by taking into account that of your competitors, but its quite another to price solely off of them. The truth is that it takes a lot of discipline and time to carefully and accurately document and cost (and recost periodically as your vendor prices change) your menu items. Moreover, you need to be well-organized, and have some reasonable math aptitude to deal with detail required to convert product prices from the way you purchase them to recipe units for costing purposes. But how can you possibly manage your restaurant's food costs if you do not even know what each and every item is costing you? All you are left with is the "let's raise the price" mentality. And while that may work in the short run, there are unquestionably better ways to proactively manage your food costs.

There are a variety of recipe-costing software products on the market, but they are of no value if you are not committed to first learning how to use them and then to continue to maintain them day in and out. A simple Excel® spreadsheet is often the best solution.

Red Flag No. 4: Food and Beverage Inventory Levels Not Counted and Costed at the End of Each Accounting Period or Recorded in Your Accounting Software

As noted, most independent restaurant operators confuse their monthly food and beverage purchases with their monthly usage. By this I mean that they review their monthly P&L (profit and loss) and assume that the food purchased during the month divided by the food sales for the same period equals the cost of goods sold for food. Not so. Without knowledge of the beginning and ending inventories you can never calculate an accurate food cost. For a restaurant with food sales of $50,000/month, an inventory difference of $1,000 between the beginning and end of the month, can translate into a variance of 2 percent. This disparity represents half the annual profit of a typical full-service restaurant. You simply cannot manage your food costs if you do not know what they are, and you cannot know what they are if you do not count and record your inventory variances. Once again, use a simple Excel spreadsheet to document, price, and total your food and beverage inventories, and then make sure to account for the changes between periods by making an appropriate accounting entry.

Red Flag No. 5: Food and Beverage Inventory Levels Too High Relative to Corresponding Sales

This red flag is not as obvious as some of the others but can be just as serious an obstacle to your restaurant's profitability. A restaurant that carries too much food inventory will inevitably have higher food costs than it would otherwise. Too much food sitting in your walk-in cooler, your freezer and your dry goods shelves will result in excess waste, overportioning, reduced product use, theft and will also tie up your most valuable asset: cash. But how do you determine how much inventory is too much or ideal? A typical full-service restaurant should have on average no more than seven days' inventory (that number can be reduced by a few days for quick-service restaurants). Follow this simple calculation to find out how many days of food inventory you have:

Multiply your average monthly food sales by your food cost percentage. Now divide that number (your average monthly food usage) by 30 (days/month):

$50,000 Food Sales/Month x 30% =
$15,000 (Food Usage)

$15,000/30 days =
$500/day of food usage

If your counted food inventory is $5,000 then divide that by your daily food usage to get the number of days of inventory on hand:

$5,000/$500 =10 days' inventory

Reduce your inventory appropriately and watch your food costs drop along with it. Follow the same procedure for your alcoholic beverage inventories and use the following as guidelines:

- ✓ Liquor: 15+ days (bars and clubs will carry more inventory than restaurants)
- ✓ Beer: 7-10 days
- ✓ Wine: 15+ days (more for restaurants that specialize in wine and/or carry many varieties)

One of the most common errors that I find when reviewing a restaurant's accounting procedures is that many different types of financial entries are posted to the wrong accounts.

Red Flag No. 6: Daily and Weekly Financial Operating Data Not Collected, Reviewed or Acted Upon

If you want to be financially successful as an independent restaurant operator you need to be more like the chains when it comes to proactive management of your business. Every chain restaurant generates some type of daily and weekly report that summarizes, in a simple and easy-to-view format, all the key daily and weekly operating data including sales (by category), labor (by department), food and beverage purchases as well as beginning and ending inventories, and other fixed expenses allocated daily to produce a weekly estimate of the restaurant's net profit. You do not have the luxury of an IT (information technology) staff like the chains to create these systems, but with some discipline you can collect this information and use it to identify problems as they happen. It is very difficult to make the corrections that are needed in your employee scheduling and product purchasing when all you have to go on is a monthly P&L that is not available to you until the middle of the following month. These corrections need to be made immediately when you have a clear understanding of what scheduling and purchasing decisions were made (or not) that produced the results that you are trying to improve upon. The good news is that all the information that you need is readily available to you from your daily POS reports and vendor bills. Again, use an Excel spreadsheet to organize this information and present it to key managers in the restaurant so they can be held accountable.

Red Flag No. 7: Inaccurate Posting of Financial Information to Your Accounting System

One of the most common errors that I find when reviewing a restaurant's accounting procedures is that many different types of financial entries are posted to the wrong accounts. This results in financial reports that are both inaccurate and misleading. Some of the most common errors I see are a restaurant's daily cash and credit receipts being recorded as income, no recognition of discounts or complimentary meals, inaccurate posting of sales tax collected, gift certificates sold recorded as revenue and not as a liability, employee wages and employer-paid payroll taxes combined as wages, recording capital expenses as ordinary expenses, posting insurance down payments and installment payments as expenses in the month paid instead of using "prepaid" accounts to spread them evenly over the year. Granted, these transactions are most likely not easily comprehended by the typical independent owner. That is why it's so important to seek professional financial help in making sure that your accounting system is set up properly from the start. If you are "flying blind" your chances of financial success will be greatly diminished, and if you cannot make a reasonable profit then all your efforts at producing a great dining experience for you customers will be irrelevant.

Red Flag No. 8: Current Liabilities Sufficiently Greater Than Current Assets as to Impair Future Ability to Pay Bills

After recording all your weekly sales and vendor bills, go to your balance sheet and divide your current assets (e.g., cash, credit card receipts in transit, accounts receivable, food and beverage inventories) by your current liabilities (e.g., vendor bills, sales tax, lease payments and short-term loans due). Consider the following example:

Current Assets = $32,000
Current Liabilities = $28,000
Current Ratio = $32,000/$28,000 = 1.14

This means that there is $1.14 of current assets for every $1 of current liabilities and is a rough measure of your ability to pay your outstanding bills. In most industries a ratio of 1:1 is considered reasonable. Restaurants typically have lower ratios because they maintain relatively small inventory levels combined with a quick cash turnover (meals are paid for the same day as they are served). Well-established and professionally run restaurants will typically have ratios of more than 1:1. Newer and less-established restaurants will almost always be below 1:1. If your ratio is below 0.7:1, then you should be concerned. While restaurants can survive for long periods with lower ratios than this, it does typically indicate that without an increase in either sales or working capital that you and your business are looking at rocky times ahead.

Red Flag No. 9: Owner Relying on Online Bank Balance to Determine Available Cash to Pay Bills

This is an easy red flag to spot, and indicates to me either the lack of a properly functioning accounting system or a basic misunderstanding of how to manage cash flow. Here is the reason why. Your online balance tells you how much cash you have at that moment of time only. It does not account for previously written checks that have not yet cleared your account or for cash or credit card deposits "in transit." You need to confidently rely on your balance sheet to tell you how much cash you have in your bank account, and this means that you need to accurately record all your sales and corresponding deposits as well as all your bills and corresponding payments on a timely basis.

Red Flag No. 10: Overall Lack of Understanding as to How to Read and Interpret Period-Ending Financial Statements

Aside from not having a well-organized and well-carried out accounting system in place (refer back to Red Flag No. 1), the most serious financial red flag that I observe is the typical independent restaurant owner's lack of understanding how to read and interpret the three fundamental financial reports readily available by all accounting software programs: profit-and-loss statement, balance sheet, and statement of cash flows. I cannot possibly do justice to this topic here, but it is critical to point out the importance to all new and existing owners of obtaining the basic financial skills that will be required for you to succeed. Get some help from your accountant, hire a consultant, take an accounting course, bring in a friend with the necessary skills, and just make sure to do something. While I must admit that I have had some clients over the years that succeed in spite of themselves, this is the exception. To be successful in this business as an independent operator you need to make sure that your financial skills are the equal of your culinary and management skills. Without all three skills working in tandem you are not giving yourself the opportunity to succeed that you deserve.

But Rome Wasn't Built in a Day

As we have noted, financial management is among the most important skills required to be successful in business, but one in which very few entrepreneurs are well-versed. In addition to this article, you might want to review "Counting Your Beans With Confidence," in the August 2005 issue of *RS&G*. Also, stay tuned for articles slated on reading your balance sheet and income statement. Finally, a course in basic managerial accounting and finance at your local college might also be a good investment in your career. The goal is to be able to continually track where money is entering and exiting your business, and the amount. Combined with your efforts to increase sales, these activities will reap rewards. **RS&G**