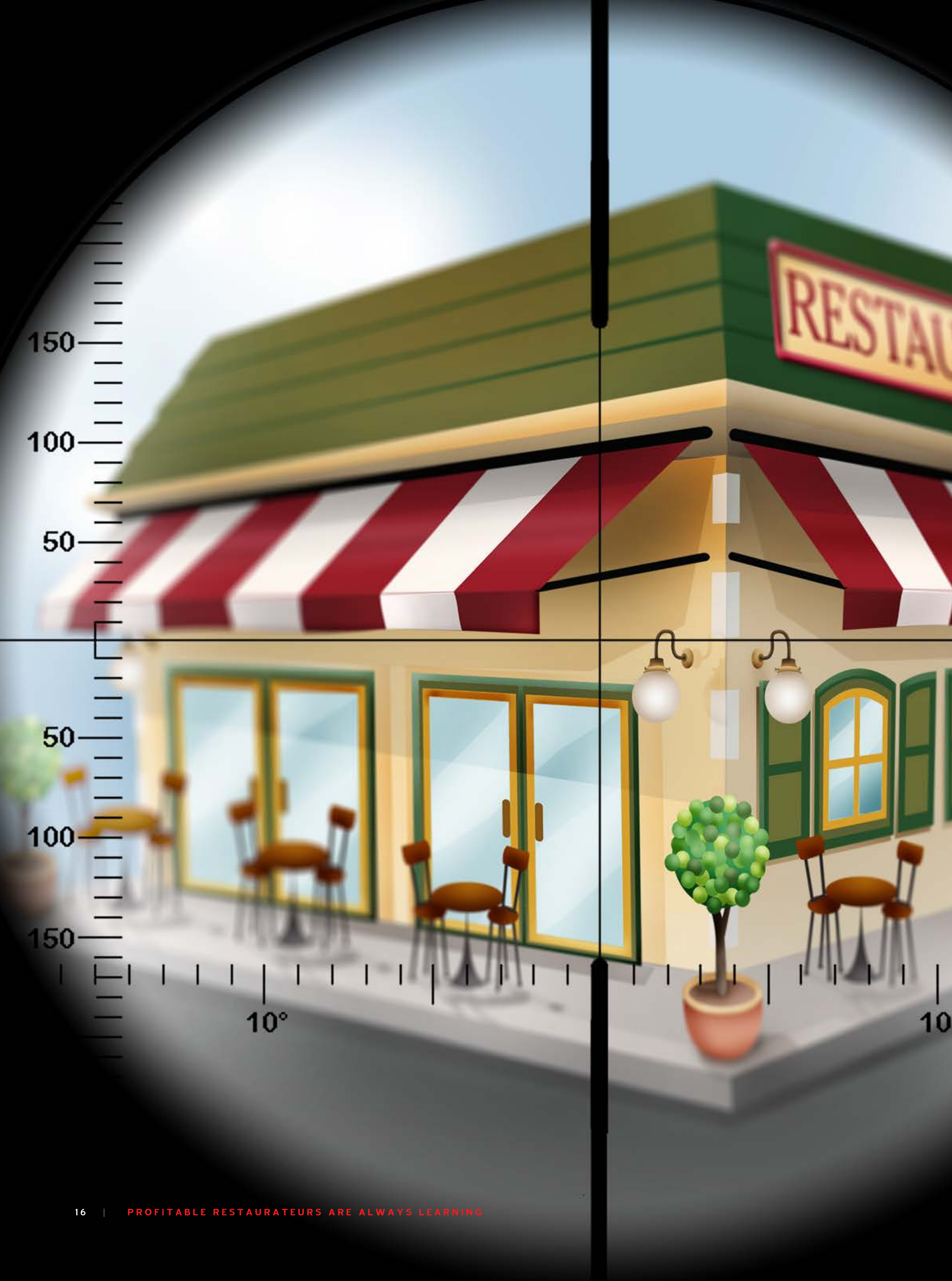
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Torpedo Alley

10 Bad Financial Practices That Can Sink Independent Restaurants

Even eliminating one or two of these torpedoes can increase your take-home returns.

By Jim Laube

Great food won't do it. And neither will impeccable service or even the best location in town.

Of course, these factors are important, but a restaurant's success will always be limited unless the owner is not only a good operator but also knows how to make their restaurant grow and prosper.

That's because creating a financially successful restaurant requires business skills and understanding basic financial concepts and controls. If you don't master these skills, you risk finding yourself adrift in a sea of competitors who are gunning for your business.

A common characteristic that we consistently see in nearly all successful independent operators is that they understand their numbers (i.e., financial statements and important metrics). They are relentless in keeping up with their key costs and margins and they understand the direct connection between the decisions and activities that take place in their restaurants and their financial results. They use their numbers to quickly measure their results so they know how well or how poorly they're doing, and if there are problems where they need to focus their attention.

Understanding your numbers and having good financial practices is the first step in protecting your assets and understanding your business. It will help you make better business decisions by relying more on facts contained in the numbers and less on intuition, suspicions and gut feeling. Following is a list of common mistakes and bad financial practices that are unfortunately quite common among independent restaurants that can't seem to sustain an adequate profit, and ultimately brings down their businesses.

1. Not Using Financial Statements to Measure Progress and Results

A restaurant's financial statements are akin to a scoreboard in a football game. Can you imagine two teams playing the Super Bowl without a scoreboard? Absurd, I know. The scoreboard shows who is winning and measures the relative successes and failures of the two teams. During the game, the ebb and flow of the score affects strategy, coaching decisions, play calling and ultimately the activities on the field.

Reading the financial statements of a restaurant should tell you the same thing. They'll reveal whether you're winning or losing (in terms of profitability) and where the restaurant is performing well and not so well. Financial statements can help you evaluate your managers' and staff's effectiveness, identify problem areas, show where you need to focus your attention and help you make better ongoing decisions.

The financial statements express in monetary terms the quality of the decisions and activities taking place in your restaurant. Good results on the financial statements are the result of good decisions and competent execution in the restaurant. Bad results mean poor decision making and/or execution in the restaurant and should tell you that something needs to change. It is amazing how many independent operators use the "seat of the pants" accounting methods.

Highly successful independent operators tend to pay very close attention to their financial statements and other key numbers. It's how they measure their progress and results in nearly every area of the restaurant.

Do you want to improve your effectiveness as an owner or manager? Start paying more attention to the numbers on your financial statements and operating reports. Are they good or bad? Getting better or worse? What are the activities or decisions that could be causing the bad results? Using your numbers to identify problems and weaknesses is the first step in doing a better job of managing or correcting the processes and activities that are causing subpar results and holding back your success.

2. Using a Generic Profit-and-Loss Statement

On the next page is a typical "generic" P&L (profit-and-loss) format similar to one that many restaurants use.

BAY STREET GRILL
PROFIT AND LOSS STATEMENT
For The Year Ended December 31, 2012

SALES		
Food	$1,302,156.00	81.4%
Beverage	298,407.00	18.6%
TOTAL	1,600,563.00	100.0%
COST OF SALES		
Food	417,992.08	26.1%
Beverages	83,113.21	5.2%
TOTAL	501,105.28	31.3%
GROSS PROFIT	1,099,457.72	68.7%
EXPENSES		
Advertising	22,943.00	1.4%
Bank charges	458.80	0.0%
Building repairs	13,485.00	0.8%
Cash (over)/short	755.28	0.0%
Cleaning supplies	9,215.70	0.6%
Complimentary meals	10,574.82	0.7%
Coupon discounts	7,849.00	0.5%
Credit card charges	26,889.12	1.7%
Depreciation	29,761.90	1.9%
Electrical	28,101.60	1.8%
Equipment repairs	5,348.47	0.3%
FICA & other taxes	40,824.91	2.6%
Group insurance	19,474.00	1.2%
Interest	43,430.80	2.7%
Kitchenware	9,941.80	0.6%
Laundry	13,415.58	0.8%
Miscellaneous	5,949.60	0.4%
Music & entertainment	10,458.80	0.7%
Paper supplies	15,215.74	1.0%
Payroll	420,875.40	26.3%
Postage	938.84	0.1%
Printing & office supplies	5,487.10	0.3%
Professional fees	18,317.37	1.1%
Property insurance	27,859.00	1.7%
Real estate taxes	48,258.80	3.0%
Rent	149,589.04	9.3%
Royalties to ASCAP	3,915.80	0.2%
Telephone & fax	5,881.80	0.4%
Trash removal	6,576.00	0.4%
Uniforms	5,124.80	0.3%
Workman's compensation	21,885.52	1.4%
TOTAL EXPENSES	1,028,803.40	64.3%
NET INCOME BEFORE TAXES	$ 70,654.31	4.4%

Now compare this "generic" P&L to one based on the National Restaurant Association's Uniform System of Accounts for Restaurants (USAR) at the right of the page:

Although the sales and expenses are the same, there is a lot more useful information on the USAR version that can help you better understand how this restaurant is performing. Here are just a few of the advantages of using the USAR format:

- Similar expenses are grouped into meaningful categories such as payroll, direct operating expenses, marketing and utilities.
- Prime cost, the total cost of sales and payroll, and one of the most important operating benchmarks in a restaurant, is shown clearly on the statement.
- Another important operating ratio, Controllable Income, often used as a margin to evaluate management's effectiveness, is also calculated and presented.
- Makes it easy to compare a restaurant's key costs, margins and ratios with other restaurants and industry averages.
- The USAR gives you a financial reporting "system" for preparing and presenting your financial results that has been proven in tens of thousands of restaurants.
- The USAR was developed by the National Restaurant Association and was recently updated in 2012. It is endorsed by *Restaurant Startup & Growth* and RestaurantOwner.com. For more information, visit www.RestaurantOwner.com/USAR.

BAY STREET GRILL
PROFIT & LOSS STATEMENT
For The Year Ended December 31, 2012

Sales:		
Food	$ 1,302,156	81.4%
Beverage	298,407	18.6%
Total Sales	1,600,563	100.0%
Cost of Sales		
Food	417,992	32.1%
Beverage	83,113	27.9%
Total Cost of Sales	501,105	31.3%
Payroll		
Management	150,500	9.4%
Staff	270,375	16.9%
Employee Benefits	72,184	4.5%
Total Payroll	493,059	30.8%
PRIME COST	**994,165**	**62.1%**
Other Controllable Expenses:		
Direct Operating Expenses	70,941	4.4%
Music & Entertainment	14,375	0.9%
Marketing	35,057	2.2%
Utilities	41,256	2.6%
General & Administrative Expenses	57,943	3.6%
Repairs & Maintenance	8,833	0.6%
Total Other Controllable Expenses	228,405	14.3%
CONTROLLABLE INCOME	**377,993**	**23.6%**
Non-Controllable Expenses:		
Occupancy Costs	234,146	14.6%
Depreciation & Amortization	29,762	1.9%
Total Non-Controllable Income	263,908	16.5%
Restaurant Operating Income	**114,085**	**7.1%**
Interest Expense	43,431	2.7%
Income before Income Taxes	**$ 70,654**	**4.4%**

3. Basing Food and Beverage Cost Percentages On 'Total' Sales

A restaurant operator once approached me at a workshop and wanted to know why his restaurant wasn't more profitable given that his food cost was consistently 28 percent or less. He showed me his P&L, and the cost-of-sales percentages looked something like this:

Sales:		
Food	$ 85,000	81.0%
Beverage	20,000	19.0%
Total Sales	105,000	100.0%
Cost of Sales		
Food	29,750	28.3%
Beverage	5,600	5.3%
Total Cost of Sales	35,350	33.7%

As you can see, each of the cost-of-sales percentages were based on "Total" Sales, not the food (or beverage) sales that correspond to food (or beverage) costs. Food cost (as a percentage of food sales) was actually closer to 35 percent.

When shown individually, food and beverage cost percentages should always be based on their corresponding or respective sales amounts, not total sales.

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* Source: Datassential Consumer Preference Survey, February 2011.

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Sales:		
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Total Cost of Sales	35,350	33.7%

4. Not Taking Account Beginning and Ending Inventory When Calculating Food and Beverage Costs

When inventory values are ignored, food and beverage costs reflect the amount of food and beverages "purchased" during the month. Food and beverage costs should show the amount of product actually "used" during the reporting period, not the amount of product purchased. To do this, a physical inventory needs to be conducted at the end of the period to determine the dollar value of the food and beverages that were purchased but remain on the shelf and not consumed. One reason chain restaurants are generally more profitable is because they do a better, systematic measurement of their inventory.

As shown below, food cost based on purchases can be materially different from the amount of food actually used when the amount of product on hand at the beginning of the period is much more or less than the amount on hand at the end of the period.

	No Inventory		With Inventory	
Food Cost Calculation				
Food Purchases	$ 6,000		$ 6,000	
Add - Beginning Inventory	-		2,000	
Deduct - Ending Inventory	-		(1,000)	
Food Cost	$ 6,000		$ 7,000	
Profit & Loss Statement				
Food Sales	$ 20,000	100%	$ 20,000	100%
Food Cost	6,000	30%	7,000	35%
Gross Margin	$ 14,000	70%	$ 13,000	65%

Some operators say that they don't conduct physical inventories because they claim their inventory levels do not deviate much during the month, so the effect on food cost is not material. While this may produce satisfactory results in some operations, our experience has shown that restaurants that take the time to conduct accurate physical inventories and use the value of their beginning and ending inventory to calculate food and beverage costs tend to do a better job of controlling their food cost than restaurants that don't.

5. Financial Statements are Based On Cash Basis Accounting

Cash basis accounting, the practice of only recording sales when cash is received or expenses when they are paid, should never be used in a restaurant.

Instead, restaurants should always use the "accrual" basis of accounting. Accrual basis means that sales are recorded when the services or products are sold and costs and expenses are recorded when products are received and services rendered regardless of when they are paid.

Sometimes accountants unfamiliar with restaurant accounting may recommend the cash basis of accounting to their restaurant clients because their clients in other industries use it. Restaurants need financial statements that reflect sales when they are earned regardless of when the cash is collected and that reflects the amount of costs and expenses incurred regardless of when the invoices are ultimately paid. This is the only way to get an accurate picture of sales, expenses and profit.

6. Food, Beverage and Labor Costs are Calculated Monthly

The most profitable restaurants we work with calculate and report their food, beverage and labor costs, commonly referred to as Prime Cost, not just at the end of the month on their P&L, but also at the end of each week.

They do it weekly for several reasons. First, food, beverage and labor costs are the biggest and most difficult to control costs in a restaurant. If there is a cost control problem, chances are very high that it's going to involve at least one of these three costs. If there's a problem, they know about it quickly and can respond accordingly, as opposed to waiting weeks for the P&L.

Weekly Prime Cost reporting also creates greater staff awareness and accountability, especially in the kitchen. Chefs and kitchen managers know that every seven days they'll find out what their food cost was for the week. This helps to keep portion control, inventory management and other food cost controls at the forefront of the minds of kitchen personnel.

Restaurants that adhere to weekly Prime Cost reporting almost always have lower food, beverage and labor costs, often by as much as 2 percent to 4 percent of sales, compared with restaurants that don't. It's the old adage: What gets measured gets managed and what gets managed improves.

7. Bookkeepers are Allowed to Handle Cash

There aren't many absolutes in the restaurant business but if there is one this is it: "No matter how long someone has been with you, no matter how much integrity you think they have, never, ever, let anyone who has access to your accounting records handle cash.'

Unfortunately many restaurant owners have had to learn this the hard way when they finally discovered that their most loyal and trusted employee, the bookkeeper, had been embezzling funds for years. Even family members can believe they have an inherited right to use company funds. It is always a difficult situation but one has to only look at the financial pages to see almost every day a company that's been exposed to this kind of fraud.

This often happens when one of the bookkeeper's responsibilities is to prepare the daily sales report and deposit slip and take the deposit to the bank. When this happens the bookkeeper has control of assets (read: cash) and the accounting records. This makes it very easy for a dishonest person to take cash out of the deposit and cover it up in the books. Unless there is some type of ongoing audit function conducted by a different individual, which there usually isn't, this problem can go on for years as long as the bookkeeper doesn't get too greedy.

The point is this: Bookkeepers should never have access to cash, inventory or any other assets of the restaurant. Closing managers or someone other than the bookkeeper should prepare the daily sales report and deposit and take the deposit to the bank.

8. Transactions In the Restaurant's Checkbook and Accounting Records are Not Reconciled

In other words, no one is preparing monthly bank reconciliations. It's hard to believe but it happens and always leads to problems. Recently a restaurateur we know discovered that his checking account had not been reconciled for three months because he'd trusted the in-house accountant. That accountant had gotten behind in other areas and simply let the checking account rise thinking she'd catch up. It came to light after the owner noticed that something didn't seem right with the balances. This is a basic accounting function.

Bank reconciliation is simply the process of verifying that your deposits, checks and other transactions in your restaurant's checkbook and accounting records match the transactions in your bank account. Typically a bookkeeper or accountant goes through the bank statement each month and verifies that each cash transaction in your restaurant was accurately recorded by the bank and inspects the bank statement for any unauthorized debits, payments or withdrawals out of the account. Any exceptions are immediately investigated and resolved.

The reason this is important is that even in our electronic, automation-driven age, banks can still make mistakes. In our business, we've had instances of missing credit card deposits, erroneous fees charged to our account as well as checks recorded twice or for the wrong amount.

If one of your deposits was missing or your bank slipped up in some other way, how would you know? Unless you or someone on your staff is reconciling your bank accounts every month, you probably wouldn't have a clue.

If you're not sure whether your bookkeeper or accountant is faithfully reconciling your bank accounts, find out now. Ask to see your latest bank reconciliations. If you get a deer-in-the-headlight stare or the last time was June 2010, you may want to make some changes.

9. Not Reporting 100% of Sales

First, skimming is against the law and the penalties are extremely severe if you're ever caught. The government gets extremely testy about tax evasion so they've made it a felony offense with significant fines and even jail time it you're convicted. And there are more reasons.

Nearly all meaningful controls are lost in restaurants that skim. Financial statements and most operating reports are essentially worthless. Operating percentages and cost ratios don't mean anything. Skimming negates the value of inventory controls. It's next to impossible for managers to know if they're doing a good or bad job of controlling expenses and whether the business is improving or deteriorating financially. It's also very difficult, if not impossible, to run the restaurant like a business and make intelligent decisions when sales are consistently and intentionally understated.

No matter how hard owners may try to hide it, one or more employees at some point are going to figure out what's going on. When they do, they may feel entitled to some of the spoils. This makes it easier for them to justify taking home a few boxes of meat or pocketing a couple of $20 bills out of the till. Some employees have been known to blackmail the operator if they're aware that skimming is a serious violation of the law. Probably most important, though, is operators who skim lack any moral authority and credibility. Integrity is an important issue for many employees and they don't respect or want to work for someone who cheats.

Finally, skimming makes a restaurant more difficult to sell. Pocketing cash off the top dramatically lowers the value of the business. Business valuations are heavily dependent on accurate, credible financial information being available. When it's not, there's nothing to justify or prove how high the sales volume is and how much profit the business is actually making.

10. Employees are Kept In the Dark

We believe that restaurant employees should know that they work in a low-margin business. They won't instinctively figure this out unless they're told. To validate, just ask a few restaurant employees how much money they think the owner makes and they're likely to say "a lot." That's because employees see, what many believe to be, large amounts of cash coming into the restaurant every day but have no concept of what it costs to operate a restaurant and how much profit remains after all the expenses are paid.

Many operators take the time to educate their employees on the low-margin nature of the restaurant business. Some do this by conducting an employee meeting and giving everyone 100 pennies. The employees are told the 100 pennies represent a dollar in sales and they're going to be shown out of every dollar of sales what it costs each month to operate the restaurant.

The employees are asked to pay 30 pennies for the food and beverage vendors, 32 for payroll and payroll taxes, 3 cents for utilities, 6 for rent and so on. After all the expenses are paid, the remaining pennies represent the amount of profit the restaurant earned. Whether there are 3, 5 or even 10 pennies left, it's a whole lot less than most employees assumed.

Now the employees have a basic understanding of the little things, like exact portioning, reducing waste and the hundreds of other seemingly meticulous steps a restaurant must take to control costs and have a shot at making a profit. At least some of them will realize the restaurant is not the moneymaking machine they may have thought.

You might use the 10 financial practices as a checklist to evaluate how you're doing in managing the financial aspects and areas of your business. The good news is that eliminating even one or two of the bad practices addressed here can go a long way to making you a more effective owner and your restaurant a more profitable and valuable business. **RS&G**