How to Go Broke Saving Money!

(Fads and Fallacies in the name of Profitability)

If “it takes money to make money”, how come people keep telling you to economize?

In these 4 entertaining stories from the food industry, Kent demonstrates the fallacy of sacrificing long-term customer service satisfaction for short-term profitability.

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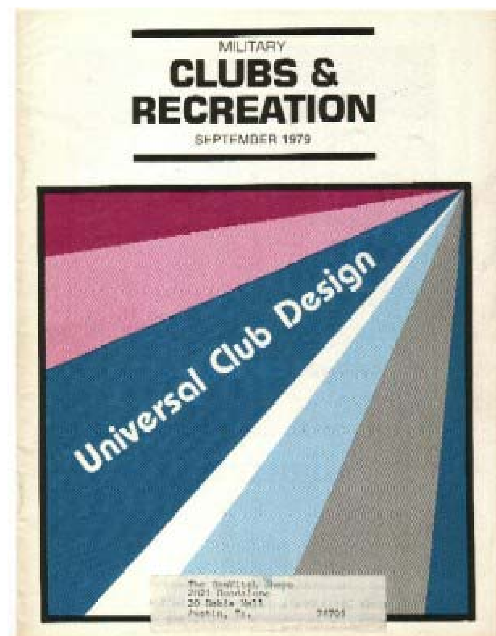

by **Kent Cummins**
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The following four case studies are *all true.* One was relayed by a food service supplier; one was published in the newspaper; the other two are based on my own observations. In each case, a food service manager made serious errors in his pursuit of profitability.

SMART OPERATOR #1: "The Coffee Has-Bean"

Sam was the manager of a medium-sized restaurant with table service. Like many of his competitors, Sam's restaurant operated on a very narrow profit margin. When the price of coffee started escalating, Sam was afraid that he was losing money on what had become his most popular beverage. Like any good manager, he decided to do some detailed financial analysis before adjusting prices.

Sam had traditionally sold a cup of coffee for 25¢ with free refills. His direct costs, which had been steadily rising, were now:

$ .04 per cup	- cost of coffee
$ .01 " "	- sugar/artificial sweetener
$ .01 " "	- non-dairy creamer
$ .06	= TOTAL COST OF COFFEE

This sounds pretty good, until you realize that almost everybody gets at least one refill, plus many cups are given away to employees and salesmen, delivery people, catering customers, etc. With these factors taken into consideration, the actual cost per cup sold becomes nearly 15¢!

Most operators would have stopped there, but not Sam—a shrewd operator who was well aware of the indirect costs associated with selling a cup of coffee.

Renewals and replacements were figured next. Sam made the following list, based on his bookkeeper's records:

Cost of one china cup	- $ 1.25
Cost of one saucer	- .70
Cost of one teaspoon	- .21
Cost of one linen napkin	- .49
TOTAL COST per place setting	$ 2.65

From historical records, Sam computed an average life per item and a weighted average per place setting, and discovered that it increased his costs of serving coffee by nearly a penny a cup.

Sam's overhead costs had much more impact. Rent, utilities, and telephone averaged $1600 per month, or $64 per day of operation. Depreciation on his coffee brewing equipment, including sales tax and installation, added 26¢ per day.

On the average, Sam sold about 200 cups of coffee a day. Dividing $64.26 (total daily overhead costs) by 200, he calculated an overhead cost per *cup of coffee* of 32¢, more than the 25¢ selling price!

In addition, of course, there was labor involved in purchasing, preparing, serving, and clean-up from coffee! Sam's average labor cost was $4.20 per hour, including benefits, which works out to *7¢* per minute. Adding up the total number of minutes which his various employees devoted to coffee, this added yet another 42¢ cost per cup served.

SUMMARY OF COFFEE COSTS PER CUP

$ .15	cost of goods sold
.01	renewals and replacements
.32	indirect overhead costs
.42	labor costs
$ .90	TOTAL COST PER CUP

By this time, Sam had accumulated combined costs of $.90 to serve just one cup of coffee. And he had not even figured in menu printing costs, utilities, interest on borrowed capital, and so many more. Why, he would have to charge almost a dollar per cup, just to break even. And to a 40 percent cost of goods sold, his coffee would have to be priced at $2.50 per cup (but with a free refill!).

Although shocked, Sam knew just what to do. Since he couldn't charge $2.50 (or even $1.00) for a cup of coffee, he ELIMINATED COFFEE FROM THE MENU ALTOGETHER!

(How do I know all this? Sam was so proud of his management prowess that he explained the whole procedure to his restaurant equipment dealer... who relayed the story to me.)

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FALLACY: Although Sam's analysis of costs may have been technically accurate, his conclusion to eliminate coffee was wrong because it eliminated a major source of customer satisfaction—without actually eliminating most of the expenses! His labor costs and indirect overhead costs stayed the same, so he actually saved only 16¢ per cup of coffee (direct costs plus renewals and replacements).

And since Sam's customers insisted on drinking coffee, they soon became customers of another restaurant.

SMART OPERATOR #2: "Burger System, Inc."

Roberto was the manager of a nationally-franchised fast food hamburger outlet. When an elderly couple was charged 40 cents each for two cups of water with their hamburgers, Roberto had this explanation:

"Kids come in all the time and want a cup of water. We give away hundreds of the small 7-ounce cups every week. But if someone asks for a larger cup, we charge for it because, for every cup that's missing, there must be money in the register accounting for that cup—except the small 7-ounce cups. This is our method of inventory control."

Through a tight system of inventory controls, this restaurant is able to compute costs within sales categories and pinpoint losses with extreme accuracy.

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FALLACY: Roberto has misplaced his priorities. Inventory control is essential, but not at the expense of customer satisfaction. When a logical-seeming rule leads to an obviously illogical conclusion (such as charging 80¢ for two cups of water with a meal), then the rule itself should be made more flexible.

If *you* had been the customer in this case, would you buy hamburgers there again?

SMART OPERATOR #3: "The Military Flop House"

The Fort Loser Officers' Place (F.L.O.P.) was a large club for Army officers, their dependents, and bona fide guests on a large training installation. In addition to the "permanent party" post population, there was usually a large contingent of students for various military schools conducted on post.

To publicize their events, the FLOP published an attractive, profession-ally-produced monthly Calendar of Events, which cost the club approximately $200 a month from a commercial printer.

Unfortunately, the FLOP was not a booming success, due primarily to a lack of management continuity. (There had been seven different managers in the past three years!) The latest manager, a brand-new graduate of the Army Club Management Course, knew that he had to do something to close the gap between income and expenses.

First, he took a careful look at activities that didn't seem to pay their own way. He eliminated Bingo, Breakfast (including Sunday Brunch), Wednesday night bands, and "International Dining" on Saturday nights. This not only saved the direct expenses of Bingo caller, bands, prizes & decorations, but greatly reduced labor costs and concurrently simplified scheduling.

Then, the new club manager found a way to save nearly $200 per month! He eliminated the fancy Calendar of Events and had a mimeographed version produced by the installation reproduction facility—at a reimbursable cost of just $18.00 per month! All of the same information was available to the members, at a 90 percent cost savings!

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FALLACY: The school-trained manager of the FLOP had forgotten one of his most important lessons: that profit is a delicate *balance* between income and expenses. Eliminating the wrong expenses will often lead to reduced sales, sometimes causing a downward spiral that makes profits still more elusive.

Although certain activities, such as Wednesday night bands, may not be profitable in themselves, they form an important part of the overall package of services which makes a club successful.

Check-cashing services, for example, are often one of the most popular services provided by a military club. Yet on the basis of income versus expenses, they would definitely have to be eliminated!

Expenses for merchandising: entertainment, publicity and promotion—should be an *investment in future profits* through increased sales, not merely an additional expense. With aggressive promotion, a marginal activity may become profitable on its own.

I was a member of the FLOP for nearly three years, but when all of my favorite activities were eliminated, I finally gave up. Like many other disgruntled and disgusted members, I resigned from the club.

SMART OPERATOR #4: "The Ice Cream Pallor"

Tony owned and operated his own small ice cream parlor. A pretty and clean establishment, it was nevertheless in a poor location, hidden in the back of an unpopular shopping center. As a result, sales were not up to Tony's expectations.

With low sales, Tony could not afford to hire enough employees to help him operate. This meant many long hours every day, with little time for Tony to be with his family. Obviously, something had to be done.

Tony had several innovative ideas for cutting costs, which I discovered the first time I visited his shop.

After buying two ice cream cones, my wife and I noticed that the napkin dispenser on the counter was empty. When we pointed this out, Tony apologized and handed us two small paper napkins from under the counter. But he didn't refill the dispenser! Knowing that we were also in the food service business, he proudly explained that he always kept the dispenser empty, thus saving the cost of napkins that might just be wasted by customers. Like us, any customer who really needs one can ask, although Tony proudly pointed out bonus savings because, "Many customers are too shy to ask!" Although napkins are relatively inexpensive, we understood when he explained, "Every little bit helps."

Later, during the same visit, my wife and I finished our ice cream cones and looked around for a water fountain. There was none. When we asked, Tony explained that he didn't have one! In addition to saving the initial cost of the equipment, he proudly explained that it forced his customers to buy soft drinks. "You pick up these little tips after you've been in business for a while." (He did get water for us, but only because we were "in the business.")

According to his customers, Tony was seen taking Styrofoam drink cups out of the garbage, rinsing them out, and using them again! He supposedly used stale bread for sandwiches rather than throw it away. And he would get absolutely furious if two customers tried to share one banana split!

One day, I dropped in to the ice cream parlor to talk to Tony about some equipment. He was in a furious mood, caused by the results from a coupon book which had been put together by a local radio station. He had placed a coupon good for a FREE BANANA SPLIT in the booklet. His complaint? Customers would come in and get the free banana split without buying anything else.

"That really made me mad," he fumed, "and I let them know it! The whole purpose of the coupon is to get extra sales."

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FALLACY: Tony's attempts to stay in business by holding down costs could actually drive him out of business.

Napkins, water, clean cups, fresh bread, and discount coupons should all be tools which build an image of service, leading to customer satisfaction. The direct costs are minimal, whereas the indirect benefits can be considerable.

Instead of building repeat business, Tony's attitude drove customers away.

SUMMARY

Well, there you have it: four actual cases of "smart" operators who, for various reasons, confused their priorities in search of profits.

Each story is true, although the names and places have been changed.

How can you avoid making similar mistakes? Put yourself in the position of your *customer,* and then figure out how you'd react.

For military clubs and recreational activities, profitability is not actually a goal ... it's a means to an end. Don't sacrifice long-term customer satisfaction for short-term profitability!