Bevinco Bar Services

Sales Tax Audit Brief

Charles Deibel
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Sales Tax Auditing Brief

We are seeking to modify some of the procedures and policies of The State of Ohio's Department of Taxation for Sales Tax compliance. This brief provides the general narrative of the situation and some of the issues we are concerned with in providing a fair and just audit.

The State of Ohio audits bars and restaurants for sales tax compliance in the effort to ensure the State is receiving the maximum amount of sales tax dollars it deserves to receive from bars and restaurants for the sales they generate for the sales of beer, liquor and wine. As I understand it, food sales are not audited.

The Sales Tax Auditing division will select restaurants and bars to test their compliance with declaring and paying the correct amount of sales tax due based on the sales the restaurants generate and report.

The following is a simplified explanation of the theory and process the Sales Tax Auditing Department takes to test for compliance.

The audit will often cover a three to four year time frame. The State Sales Tax Auditor will pull the purchase records for all alcohol beverage inventory for the period of the audit.

The auditor will obtain from the Operator the pricing of the drinks sold, along with the recipes and pour sizes. Using this information, along with the purchases the auditor will back into the amount of sales the bar should have generated based on the amount of inventory it went through. After the theoretical gross sales are calculated, the auditor will deduct an amount of the top for "shrinkage" of inventory; meaning inventory that was wasted due to sloppiness, waste, spillage, giveaways, over-pouring. The end result is the net sales, which will be compared to the reported sales. If there is a difference, that difference is considered to exist as a result of the owner skimming the money off the top of what was reported. Consequently, since money was changed hands and the operator received it, but did not report the sales, thus reducing the reported sales, which in turn reduces the amount of sales tax calculated and paid to the State of Ohio.

We have several issues with the process and calculations the State of Ohio Sales Tax auditors use In the course of their audit, believing them to be unfair and cause the operator to pay an unjust amount (Objectively, it's inaccurate. For all we know the State could be coming up on the short end of this), thus putting their business in jeopardy.

The first issue is the premise that the record keeping of the operator is insufficient.

Many years ago, this might have been more accurate. Operators were able to easily skim off the top amounts of sales into their pockets. The operations were smaller and were usually managed on daily basis in a very hands on approach by the owners. Most sales were by cash, not credit card. The registers utilized were manual cash registers which produced a journal tape that only provided gross sales numbers with little if not any detail regarding what was sold.

In the last 10 to 15 years equipment technology and payment methods have radically changed, making this almost impossible.

Almost all bars and restaurants utilize state of the art computer systems, providing specific transaction data, which is then summarized by sales categories. The computer systems used the most are Aloha, Micros, Two Touch, Lavu, Pixel Point, Restaurant Manager, Digital Dining, Touch Bistro, Future, among others.

Related to the overwhelming use of these systems by almost all restaurants and bars (from single unit operators to multi-unit operators) is the proliferation in the use of credit cards and debit cards for payment by the customer. It has reached epic proportions, closing in on 90% of all transactions. This single fact makes it virtually impossible to embezzle large amounts of money from the establishment by the owner, without it leaving an audit trail via the depositing bank for the credit card sales.

The second issue are the amounts utilized for shrinkage by the State of Ohio.

This is another area of concern for us in the industry. The State's Sales Tax division utilizes amounts of shrinkage that are unrealistically small. It seems the numbers were just arbitrarily determined by members in the department with no real study or bar experience to base the numbers decided on.

Inventory shrinkage occurs as a result of employee theft, spillage, carelessness, over-pouring, giveaways, improper recipe adherence, breakage, etc. Because of these issues the State allows a certain amount of shrinkage to be reasonable. They allow an owner to have inventory shrinkage of 10% for liquor, 5% for wine and draft beer and no shrinkage allowable for bottled beer.

We believe these numbers should be higher based on certain issues being present. We have independent data that supports these assertions.

Summary of Data

Number of Bars and Restaurants in Sample 326

Percentage of Bars and Restaurants that exceed the State Allowance for Shrinkage

Liquor	86.9%
Wine	82.8%
Bottle Beer	96.2%
Draft Beer	87.5%

The average shrinkage for each category was

Category	Actual	State Amount
Liquor	22.1%	10%
Wine	19.2%	5%
Bottle Beer	10.6%	0%
Draft Beer	16.3%	5%

For each inventory class there was at least one restaurant with a 0% shrinkage.

The highest level of shrinkage for each inventory class was:

Liquor	54.3%
Wine	88.4%
Bottle Beer	37.8%
Draft Beer	63.2%

The basic tenet here is how can the operator pay a tax on a sale that did not actually occur? Just because the inventory was used, doesn't mean the sale was recorded and money exchanged hands for the proper amount of inventory used. Often, money did not change hands. These operators wanted these shrinkage issues to be resolved and eliminated.

The third issue are the calculations the State uses to determine the ideal amount of sales.

The method employed by the State has the agent taking purchases for one year out of the 3 being reviewed. He utilizes a statistical sampling method to calculate what the product mix and sales mark-up percentage should be based on the usage of the inventory based on the purchases records for that one year. He then calculates what the sales should have been for that year based on this product mix and amount of purchases. Then he deducts from that gross sales number a percentage for allowable shrinkage. He then compares that net sales amount to the actual sales reported. The difference between the two numbers results in a percentage

of sales that are supposedly not reported for that year. The agent will then take that same percentage and apply it to the other years being reviewed to arrive at the proposed projected unreportable taxable sales for each year.

The methods used by the state ignores the existence of and use of actual product mix information available to calculate the ideal amount of sales based on purchases. In fact, when queried as to why they don't use a product mix report from the POS system, one of their agents said they had no idea what information is on that report. The report in question is called a Menu item Detail Report and it's an Industry Standard report utilized by all bars and restaurants to understand their product mix for proper ordering, cost and sales analysis. By using this report, the agent would not have to take long and painstaking hours to calculate an estimated product mix, but could simply obtain it. In addition, he could then also run one for each other time period under review as well, as opposed to applying a product mix for one year to other years, when product mix is a very dynamic and changing number.

In contrast to the State's methodology and the correct cost accounting methodology for calculating shrinkage, exists the traditional hospitality industry standard of analyzing their operations by comparing their current actual cost percentages against past actual cost percentages or industry standards and not calculating their ideal cost percentages based on their product mix. This puts the average operator in a position of not being fully aware of how much sales and inventory they are missing.

Twenty years ago very few restaurants used the correct method for calculating shrinkage, today, more than half of the large chain restaurant groups use the correct theoretical method in some manner. However, that only comprises a small fraction of the thousands of restaurants and bars that exist as being operated by independents.

Summary

We have found over the years that bars and restaurants experience fairly high amounts of shrinkage. On average by about 20%. This is not caused by the owners skimming money off the top, but by a combination of Industry standards for cost and sales analysis that are incorrect, along with a genuine high amount of employee initiated losses, either through accident or on purpose.

The existence of the shrinkage is simply an issue of the owner not receiving the amount of sales they should be due to a number of events, none of which have to do with them not declaring actual sales in an attempt to avoid paying the sales tax that was collected or income taxes; consequently, how can they pay sales tax on sales that did not occur?

It could almost be said the State is using this as a money grab and taking advantage of the small business person in Ohio. If the sales and the sales tax were not charged and collected from the customer by the restaurant operator, how can they be held to pay it to the State?

We are proposing a discussion on the issue to identify the different options available and to develop a more fair system and which utilize shrinkage numbers that are realistic to determine if a business is reporting the correct amount of sales, thus collecting and reporting and paying the correct amount of tax on those sales. The restaurant business is a very difficult one, with slim bottom line margins and increasing bureaucracy. It employs thousands of people in Ohio. Not changing these procedures is putting many restaurants at risk of having to close their doors.

Some of the changes would involve the Department of Taxation for the State of Ohio updating some of their auditing procedures and calculations, along with increasing the amounts used for shrinkage.

It could also involve a more proactive approach of education and testing when a person applies for a liquor license, along with an investigation as to why the Department does not employ the same strategy on food sales in a restaurant. There is also the idea that if a restaurant can provide an independent cost analysis that could somehow provide relief from an audit.

Also, another idea is if a restaurant utilized the correct analysis methods, the amount of allowable shrinkage could be at a different rate.