Fighting Fraud—and Serving Famous Frankfurters—for Over a Century

The Story of Old-Fashioned Controls at Nathan's Famous

By Howard B. Levy

One hundred years ago, an enterprising, bright, savvy, but uneducated young Polish immigrant started a modest business that would eventually grow to become one of the most beloved food service establishments in the world: Nathan's Famous. Anchored in the heart of legendary Coney Island, the original location is most fondly remembered by those who once lived in Brooklyn. It has been said (though it cannot be proven) that one in seven Americans can trace their roots to Brooklyn [Norman Oder, "Lifespan of a (Brooklyn) Fact: Can One in Seven Americans Trace Roots to Brooklyn?" Aug. 8, 2012, http://bit.ly/2bFvgEw]. For Brooklynites of a certain generation, Nathan's Famous is, perhaps, second in its nostalgic value only to the late, lamented Ebbets Field.

Although the term "fast food" would not come into use for another 40 years, many regard Nathan's Famous as the beginning of that industry. With his rapidly growing hot dog stand firing off frankfurters at breakneck speed, Nathan Handwerker, the "Henry Ford of the American Hot Dog," soon realized that his startup business was highly vulnerable to the risk of employee theft and that its success depended primarily on controlling against such theft—especially because of the narrow margins realized from selling hot dogs for only a nickel (a price Nathan was able to hold the line on, even into World War II).

The risk of employee theft increased as the enterprise grew and required that Nathan devise procedures to control the handling of both cash and inventory in a way that would adequately protect him and his business. He had to rely on his own inventiveness, since he could not read about the subject for two com-

pelling reasons. The first is that the concept of internal control was not yet fully developed or written about; the principal reference source used by auditors, *Auditing Theory and Practice* (Robert H. Montgomery, second edition, 1916), did not even use the term, instead using "internal check." The second reason was that Nathan was functionally illiterate.

The Scope of Employee Theft in the Restaurant Industry

Historically, the risk of employee theft in retail businesses has posed challenges to auditors and operators manifested in the form of unrecorded revenues (the completeness assertion, to an auditor) due to skimming and inventory "shrinkage" (in food service, literally eating the profits). Today, the former may be particularly significant in the fast food industry as a result of its substantially higher concentration of cash (as opposed to credit) sales; as with a casino, the transfer of large amounts of cash in public areas poses special risks. As stated in a 2016 article from *QSR Magazine*, a quick service restaurant industry publication, "free food items passed along to friends and family, cash pocketed at the drive-thru window, items tossed out with the trash—ask any quick-serve operator, and almost every one will have a tale of a different tactic taken by an employee regarding theft" ("Employee Theft Creates Problems for Restaurant Crews," http://bit.ly/2bWNaBW).

Today, the risk of employee theft in cash businesses is managed primarily by technology, such as elaborate security/video surveillance and kitchen management systems, modern point-of-sale (POS) cash registers, and other cash handling equipment. Modern technology notwithstanding, the National Restaurant Association reported in 2015 that employee theft accounts for more than 3% of annual food service sales ("How to Prevent Employee Theft in Your Restaurant," Focus POS Systems, http://bit.ly/2cKnJCx). In 2003, the *Houston Chronicle* reported that estimate to be 4–5% of annual sales (Jackie Lohrey, "Internal Control in Restaurants," http://bit.ly/2cKpWOk), and a 2004 report cited by the School of Hotel and Restaurant Administration at Oklahoma State University placed the estimate at $3 to $6 billion (Hayley Holmes, "Employee Theft in Restaurants: Perceptions about Theft-Related Activities and Reporting Behaviors," http://bit.ly/2cTod9G). The sidebar, *Suggested Additional Reading*, features a selection of online articles detailing the foregoing estimates and modern fraud protection methods, all of which were virtually unheard of in the early days of Nathan's Famous.

Nathan's fledgling food service business could not afford even the primitive but expensive cash registers available at the time, and it's likely he reasoned that their use would slow down the lightning-speed service that his business depended upon for its sales volume. Instead, customers' nickels, dimes, quarters, and bills were dropped into cigar boxes. Working as much as 20 hours per day during peak times (when the "store," as Nathan called it, was open 24 hours), and assisted when necessary by trusted family members, Nathan himself was the de facto surveillance system.

Nathan's Low-Tech Solution

In his book, *Famous Nathan: A Family Saga of Coney Island, the American Dream, and the Search for the Perfect Hot Dog*, Nathan's grandson Lloyd Handwerker tells his grandfather's story from the founding of the restaurant through both world wars and the Great Depression, through Nathan's retirement in 1971 and death three years later. Lloyd devotes much of one chapter to how Nathan successfully managed the formidable risk of employee theft: "His approach to recordkeeping was crude in the extreme … scribbling business records on the back of a wall. … The accounting geniuses at a top firm like PricewaterhouseCoopers might not approve, but it worked for Nathan." Lloyd also quotes an observer who said that "the place was run with procedures that rivaled IBM. … business and management practices that Nathan put in place addressed problems of employee theft, yes, but also issues of inventory, production, and sales … [and] a system gradually came to control all aspects of cooking, serving, supplying, and managing the menu items for which customers eagerly lined up." Sidney Handwerker, a former Nathan's manager, told Lloyd, "Everything at Nathan's was counted. The frankfurters, the rolls, the french fry bags, everything." As a result, Nathan had a daily accountability; for example, for every frankfurter authorized to be given away and every broken one thrown away. He always knew how much of everything he should have at any given time and

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"compared the tally with the amount in the till."

Astonishingly, Nathan "basically kept track of the store's whole business in his head." Lloyd tells a story about how his grandfather instantly picked out a $10,000 inventory error in a financial statement presented to him by the company's accountant. Cash currency (coins and bills) was accounted for with the same vigilance and obsession, if not more; until after World War II, all counting and coin rolling was done by hand, usually under the watchful eyes of Nathan or his oldest son, Murray.

Every accountant knows, and every entrepreneur should know, that in a small business, owner-manager supervision is a key element of internal control, particularly in mitigating the risk of employee theft. Most written discussions of modern methods of managing this risk argue that the employees' knowledge that they are being watched is among the most effective deterrents for improper behavior. Although unschooled in matters of business, Nathan knew this instinctively, and Lloyd's book is laden with repeated references throughout to Nathan's omnipresence as a one-man surveillance system. As the size of the original store and its hours of operation grew, Nathan relied on his sons and other trusted family members and long-term employees to occasionally fill in on watch duty.

Filling his employee ranks with trusted family members, to the extent possible, was another effective element of Nathan's internal control structure. He truly viewed his as a family business, and his poverty-burdened background—both as a young man growing up in Europe and a struggling immigrant in New York City—taught him that family supports family. He also believed that in the unlikely event that a family member were to steal from him, it would not be so bad, because he would be helping family.

Psychologists and other experts recognize that an unhappy employee is far more likely to steal than one who is satisfied. Therefore, employee loyalty is another effective element of control against theft that Nathan understood well. Although Nathan enforced his many rules and requirements of his employees "with an iron hand," and worked them hard, he paid them well and otherwise treated them fairly and with compassion, even offering them financial help when they needed it. In fact, he was said to maintain a paternal attitude toward his most trusted employees, many of whom stayed with him up to 50 years.

An Enduring Legacy

Nathan Handwerker may not have had a computerized POS or inventory system, closed-circuit TV cameras, or a legion of corporate accountants at his beck and call, but, judging by the survival of the company 100 years later, his methods for controlling employee theft worked out pretty well. ❑

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SUGGESTED ADDITIONAL READING

- Kendall Austin, "5 Ways Your Staff is Stealing From Your Restaurant Right Now," *Toast*, May 19, 2015, https://pos.toasttab.com/blog/ways-your-staff-is-stealing-from-your-restaurant-now
- Cherryh Cansler, "Using Technology to Stop Restaurant Theft," *Fast Casual*, Sept. 16, 2013, http://www.fastcasual.com/articles/using-technology-to-stop-restaurant-theft/
- Steven Johnson, "Theft in Foodservice," FoodService Director, July 29, 2013, http://www.foodservicedirector.com/managing-your-business/controlling-costs/articles/theft-foodservice
- Jackie Lohrey, "Internal Control in Restaurants," *Houston Chronicle*, http://smallbusiness.chron.com/internal-control-restaurants-74765.html
- Lori Mealey, "How to Prevent Employee Theft," *The Balance*, updated May 4, 2016, http://restaurants.about.com/od/staffingarestaurant/ht/Employee_Theft.htm
- "Preventing Employee Theft in Your Restaurant," Bolt Insurance, Nov. 21, 2012, https://www.boltinsurance.com/preventing-employee-theft-in-your-restaurant/
- "Restaurant Theft and the Hard Truth About Losses in the Food Industry," LPI Innovations, http://cdn2.hubspot.net/hub/31499/file-271254222-pdf/Restaurant_Theft.pdf