



Restaurant operating expenses and their effects on profitability enhancement

Sung Gyun Mun^a, SooCheong (Shawn) Jang^{b,*}

^a School of Hotel and Tourism Management, Hong Kong Polytechnic University, 17 Science Museum Road, TST East, Kowloon, Hong Kong

^b School of Hospitality and Tourism Management, Purdue University, Marriott Hall, 900 W. State Street, West Lafayette, IN 47907, USA



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ABSTRACT

Restaurant firms need efficient cost management strategies due to highly competitive market conditions and the weak financial structure of the restaurant industry. In this regard, the objectives of this study were to examine the operating expenses of restaurant firms and their impact on profitability enhancement by business segment and firm size. This study found that high prime costs (food costs and salary expenses) could be a major concern for full-service restaurant businesses and cause lower profitability compared with their limited-service counterparts. Improving the operational performance of full-service restaurants depends on sophisticated cost retrenchment skills, such as balancing productivity and revenues while minimizing quality detrimental. Further, firm size had an impact due to economies of scale decreasing food costs. Nevertheless, managers of limited-service restaurants, especially large firms, need to consider improving food quality instead of relying on advertising effects to maximize profits.

1. Introduction

The restaurant industry has witnessed fast sales growth (13% per year) over the past 30 years, although the revenue growth rate recently decreased to around 4% per year (NRA, 2014). Despite continuous business growth, restaurant firms' low operating profitability, lack of financial flexibility, and highly competitive market environment are chronic industry-wide challenges with no sign of improvement (DeFranco and Lattin, 2006). The inherent difficulties are mainly due to the nature of restaurant business, such as low entry barriers (e.g. small amount of required capital), high proportion of operating expenses (e.g. food costs, labor costs, and rent expenses), and the existence of many substitutions in the market (DeFranco and Lattin, 2006; Assaf et al., 2011). In addition, readily accessible information on customer review sites (e.g. Yelp and Trip Advisor) about food quality, price, taste, promotions, service quality, and restaurant facilities intensify the competition among restaurant firms for limited resources in every aspect of business. Furthermore, frequent changes in legislation (e.g. minimum wage, hygiene, and nutrition), globalization, evolving technologies, unexpected natural events (e.g. SARS, hurricane, and terrorist attacks), and emerging competitors (e.g. food trucks and delivery services) add levels of complexity and vulnerability to the restaurant industry (Parsa et al., 2011).

The fundamental weaknesses of the restaurant industry are too distinctive to overlook or underestimate. According to Lee et al. (2016),

in Australia 99% of restaurant firms were small and medium enterprises and 63% of restaurants earned less than 2% net profit. In a study by Parsa et al. (2011), 25% to 49% of restaurant firms failed during the first year of operation in the U.S. due to a lack of financial and human resources. Kim and Gu (2006) also suggested that restaurant firms' low profitability and insufficient financial flexibility were the most prominent indicators of business failure in U.S. Due to this industry-wide vulnerability in terms of operational and financial aspects even a 1% or 2% increase in operating expense can easily force a restaurant firm into a cash flow shortfall or to operate at a deficit. Therefore, the importance of management competence in realms such as controlling operating costs and financial management cannot be overemphasized enough to sustain a business (Youn and Gu, 2010; Parsa et al., 2011; Assaf et al., 2011; Alonso and Krajsic, 2014).

Despite the strategic value and importance of cost management, surprisingly limited attention has been paid to the effectiveness of cost management practices in the hospitality research field (Kim et al., 2007). According to Hesford and Potter (2010), only one study (e.g., Chan and Au, 1998) in the Cornell Hospitality Quarterly examined the practices of cost management in the restaurant industry from 1979 to 2008. Further, Park and Jang (2014) extensively reviewed four peer-reviewed hospitality journals and found that the topic of cost management or cost accounting was not typically studied in the hospitality industry from 1990 to 2013. Instead, much more effort has been

* Corresponding author.

E-mail addresses: sung.mun@polyu.edu.hk (S.G. Mun), jang12@purdue.edu (S.S. Jang).

devoted to understanding the relationship among food quality, service quality, customers' satisfaction, and behavioral intentions (Namkung and Jang, 2007; Kim et al., 2009; Tsaur et al., 2015; Peng et al., 2017). These studies mostly relied on customer survey questionnaires without controlling for cost and price effects in the models. In other words, the studies did not reflect the simple but very important fact that improved food or service quality inevitably increases related expenses and often menu prices, which ultimately influences the firm's sales and profitability. Consequently, the previous findings had serious limitations in terms of providing appropriate answers to the following question: Among restaurant quality attributes, such as food, service, and marketing, which aspect should restaurant managers pay more attention to in order to enhance profitability?

The answers to the above question are important not only for restaurant firms that strive for better business performance but also for restaurant firms that struggle with poor performance. Although cost or asset retrenchment, such as layoffs or selling-off properties, are the most frequently used strategies when a restaurant firm faces operational difficulties, the efficacy of these strategies is generally limited and has been shown to work for only a small number of firms in matured industries (Morrow et al., 2004). For example, Kukanja and Planinc (2013) found that cost reduction strategies had a negative impact on long-term restaurant firm performance and argued that a lack of scientific research and professional guidelines impedes efficient cost management practices for restaurant managers. Alonso-Almeida et al. (2015) revealed that the negative effects of cost cutting are caused by deteriorated service and food quality when restaurant firms focus on immediate savings rather than strategic effects. Considering that restaurant firms typically have high operating costs and low profitability, the results are surprising because cost reduction or asset retrenchment strategies are the first choice for most restaurant managers faced with overcoming operational and financial difficulties (Alonso-Almeida et al., 2015). However, the findings evidently indicate that if overly simplified cost reduction or asset retrenchment strategies fail to account for the significance of each operating expense or assets, then the strategy obscures operational effectiveness as a whole.

To fully understand the effects of cost management strategies on restaurant firm performance, it is essential to examine the relationship between all of a restaurant firm's operating expenses and profitability—not only individually but also jointly. Nevertheless, previous studies only investigated the impact of each type of operational expense on operational performance separately but not jointly. A few studies have examined the unilateral effects of food quality (Sulek and Hensley, 2004; Namkung and Jang, 2007), advertising expenses (Hsu and Jang, 2008; Park and Jang, 2012), or employee compensation (MacDonald and Aaronson, 2006; Fougère et al., 2010) on a restaurant firm's operational performance. Yet these results may provide incomplete information and lead to inappropriate strategic decisions (Assaf et al., 2011). Hence, it is obvious that the efficiency of each operating expense cannot be understood properly without controlling for other operating expenses. Thus, this study aimed to fill these research gaps. Specifically, the objectives of this study were to empirically examine all operating expenses that restaurant firms incur and to simultaneously analyze their impact on profitability enhancement. For this reason, this study did not intend to provide theoretical underpinnings for cost management practices but rather aimed to suggest practical implications through analyses. Thus, this study is purely exploratory in nature.

To provide more meaningful implications, this study also considered the fact that the characteristics of a restaurant firm can significantly differ by business segment (limited-service or full-service restaurant) and firm size in terms of food quality, employee roles, expected service, reputation, market shares, economies of scale, etc. The food at full-service restaurants is less standardized and more complicated than the food at limited-service restaurants. Thus, food quality is a critical factor influencing customers' satisfaction and revisit intentions at full-service restaurants but speed of service and menu prices are significant factors

for limited-service restaurants (Fougère et al., 2010). Another example is that the roles and expectations of full-service restaurant employees who interact with customers for a longer period of time differ from those of limited-service restaurant employees who have limited customer contacts (Fougère et al., 2010). From another angle, cost management practices at smaller restaurants often differ from large restaurants due to the difficulties in supply management, hiring skilled workers, and obtaining financial resources (Beck and Demircuc-Kunt, 2006). In this regard, it would be reasonable to examine the efficiency of operating expenses and the effectiveness of cost management strategies separately by restaurant type and firm size.

In short, this study intended to identify which operating expenses restaurant managers should pay more attention to in order to improve profitability. To the best of the authors' knowledge, this study is the first to investigate the comparative effects of each operating expense on restaurant firms' profitability enhancement using accounting information.

2. Literature review

2.1. Food costs

Food costs are the foremost and largest portion of operating expenses for a restaurant business. The food cost ratio (food costs/sales) increases if a change in unit food costs is higher than the corresponding change to the unit menu price. For example, the food cost ratio increases when a restaurant firm uses better quality but more expensive ingredients, such as organic vegetables, antibiotic-free hogs, or free-range chickens, relative to its menu prices. If this is the case, it is reasonable to expect that the food cost ratio (or food quality) has a positive relationship with sales because food quality is one of the most important determinants of restaurant customers' revisit intentions, as previous studies have illustrated (Susskind and Chan, 2000; Sulek and Hensley, 2004; Namkung and Jang, 2007).

However, if the increased expenditure for better ingredients (or food quality) causes a significant increase in menu prices without noticeable improvement in customers' perceptions of food quality, then the restaurant's sales will not increase as much as expected and, consequently, its operational performance will deteriorate (Min and Min, 2011). This is because customers tend to react negatively to price changes; restaurant customers are more likely to be displeased by unexpected price increases rather than expected price changes (e.g. antagonization costs) (Rotemberg, 2005). To minimize antagonization costs, restaurant managers need to represent price increase in tangible ways, such as developing menus with clearly improved food quality or remarkably adding values for menu items. The theory of utility explains that consumers derive value based on the trade-off between the 'utility' attributes (or perceived value (Zeithaml, 1988)) of a product and the 'disutility' represented by the price paid for the product (Tellis and Gaeth, 1990). In this sense, an increased food cost ratio (or food quality) does not always have positive effect on a firm's operational performance since consumers' perceptions of value are related not only to food quality but also menu prices (Zeithaml, 1988; Agarwal and Teas, 2002). Previous findings also supported that food prices are an indispensable factor in determining food choices (Epstein et al., 2007).

Along the same lines, the effect of an increased food cost ratio (or food quality) on sales growth would significantly differ based on current food quality (or the level of the current food cost ratio). If a restaurant firm has high food quality (or low menu prices relative to food costs), then increasing the food cost ratio (or food quality) would have a weak or even negative impact on profitability. However, if a firm has low food quality (or high menu prices relative to food costs), then the firm might be able to increase its food cost ratio (or food quality) without changing menu prices. This would have a strong positive effect on sales growth. According to Monroe (1979), price has a negative effect on a product's value although it has a positive relationship with

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