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The influence of firm characteristics on earnings quality

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ABSTRACT

This study examines the effect of firm characteristics on earnings quality using a sample of Spanish hotel firms during the period 2000–2011. First, we build a multidimensional measure of earnings quality including attributes as persistence, predictability, variability and earnings smoothing. Second, we examine variables that are potentially associated with earnings quality and sort these into five categories: market variables, business strategy, ownership structure, audit function and control variables. The findings suggest that the internationalization, the location, the ownership structure and the audit function influence earnings quality in hotel firms. This paper presents managerial implications for professionals, users of financial information, and academics.

1. Introduction

Financial reports are the primary source of publicly available information about a company's financial position and performance. The earnings figure is the most important firm indicator as provided useful information about the firm's valuation and are highly influential in decision-making (Schipper and Vincent, 2003; Francis et al., 2004).

Earnings measured as occupancy rate, return on assets, return on equity, stock return, has been widely used as an indicator for business performance in hospitality literature (see, e.g. Kim and Gu, 2005; Chen, 2010; Turner and Guilding, 2011; Guillet et al., 2012; Chen et al., 2012; Xiao et al., 2012). Macro environment factors and company-specific factors has been extensively studied as key variables that can help to enhance the earnings (see, e.g. Álvarez Gil et al., 2001; Chen, 2010). Empirical studies have demonstrated that variables such as the growth rate of total foreign tourist arrivals, financial crises, natural disasters, political events, location, internationalization, brand image, etc., seem to affect tourism firms' strategic orientation as well as their performance. It is also noted that the corporate governance and the ownership structure influence on hotel performance (Brady and Conlin, 2004; Perrigot et al., 2009; Turner and Guilding, 2011; Chen et al., 2012; Xiao et al., 2012). Nonetheless, although several authors have studied accounting quality in the hospitality and tourism literature, no work to date has focused on earnings quality measured considering a set of attributes and consequently this study represents an important step in the hospitality field.

Because earnings are widely used in various scenarios, the quality of reported earnings and their usefulness has attracted the attention of academics, professionals and standard setters. However, much of the empirical literature in this area focuses on publicly held companies compared to their privately held counterparts. The greater data availability for public firms likely explains this discrepancy. Morrison et al. (2010) analyze the key contributions to small tourism business research concluding that this field is a rich and fertile site for research activity.

Combining two literatures—earnings quality in private firms and the hospitality field—we develop our hypothesis. Earnings quality in private firms has garnered considerable academic and public interest (Ali et al., 2007; Yang, 2010; Hope et al., 2013). The determinants that engage in more earnings quality have attracted the attention of academics, professionals and standard setters. Most previous research has focused on monitoring mechanisms such as the ownership structure, the concentration of ownership as drivers of earnings quality (see, e.g., Wang, 2006; Ali et al., 2007; Hope et al., 2013). Additionally, the effects of tax compliance (Burgstahler et al., 2006; Van Tendeloo and Vanstralaen, 2008; Kosi and Valentincic, 2013) and debt covenants (Watts and Zimmerman, 1986; Kosi and Valentincic, 2013) are also factors directly linked to earnings quality.

In hospitality field, several authors have focused on the financial reporting and their quality. For example, Jeon et al. (2004) focus on persistence of abnormal earnings to analyze the quality of earnings in hotel companies. Turner and Guilding (2011) explain the manager's incentives to use accounting choices (capitalization or expensing of asset related expenditures) to alter the earnings

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figure. Parte Esteban and Such Devesa (2011a,b) focus on reported earnings and demonstrate the importance to reach certain earnings benchmarks (small profits against small losses). All of these studies have used individual earnings quality measures to demonstrate their hypothesis and our study includes earnings quality measurement based on a set of attributes.

The objective of this paper is to analyze the earnings quality and its determinants. First, we develop a multidimensional concept of earnings quality through four earnings attributes: persistence, predictability, smoothing and variability. Second, we explore the determinants of earnings quality. We explicitly consider a set of variables demonstrated to affect earnings quality in previous research such as leverage, size and ownership structure (Francis et al., 2004; Gaio, 2010) and re-examine the evidence using a sample of hotel firms and a multidimensional concept of earnings quality. Moreover, we examine the influence of variables such as the firm's business model (location, internationalization or primary activity of the company) and macroeconomics conditions (financial crisis) that remain open questions in the field of earnings quality. Our research attempts to fill this gap in the literature. That is, we explore the earnings quality measured as a multidimensional concept in a sample of hotel firms and propose a set of determinants that potentially influence on earnings quality. Our empirical design provides evidence for the relative importance of individual factors and their interaction in shaping reported earnings.

We focus on the tourism industry because it is a fundamental sector of the Spanish economy. The contribution of the sector to Gross Domestic Product (GDP) was approximately 15.2% in 2012. Spain receives the second most tourism revenue in the world and the most revenue in Europe (OMT, 2013). Specifically, the hotel sub-sector is considered one of the most important industries in the Spanish economy.

Our sample includes all hotels firms reporting financial statements over the period 2000–2011. In the first stage, we compute earnings quality for each firm through four individual measures: persistence, predictability, smoothness and variability. Then, we create an aggregate earnings quality measure for each firm by averaging the four individual measures. Higher rankings indicate higher levels of earnings quality. In the second stage, we define a set of variables that potentially influence earnings quality. To increase the robustness of the analysis, we divide the factors into the following groups: market variables, business strategy, ownership structure, audit function and control variables. We analyze these factors individually and then examine them together.

The results indicate that audit function and some factors related to business strategy are strong drivers of earnings quality in hotels firms. We also find that larger firms have higher earnings quality rankings, while firms with higher sales volatility, greater operating cash flow volatility, and a higher incidence of losses have lower earnings quality rankings. The evidence presents strategic implications for hoteliers, accounting standard setters and academics.

Our contribution to the literature is to analyze additional determinants of the earnings quality tendencies of private firms. Because the majority of companies in the global economy are private and family-controlled firms (La Porta et al., 1999), our study extends previous research on the earnings quality of private firms and their determinants in several ways. In particular, this study sheds light on a seminal paper in the hospitality industry by Jeon et al. (2004) that examines the earnings quality of Korean hotel firms using the persistence of earnings. This study supports the conceptualization of earnings quality as a multidimensional measure.

Furthermore, this study extends the literature on earnings quality in private firms and the hotel industry by including several determinants of earnings quality. Previous studies typically focus on one variable such as managerial style (Chen et al., 2012; Xiao et al., 2012), the link between performance and CEO compensation (Kim and Gu, 2005; Barber et al., 2006; Guillet et al., 2012), factors affecting systematic risk for the hotel industry (Kim et al., 2012), the effect of the financial crisis on the hotel performance (Chaston, 2012; Alonso-Almeida and Bremser, 2013), among others. In this study, however, we include general variables previously documented to influence earnings quality (Francis et al., 2004; Gaio, 2010) as well as specific variables related to the hotel companies such as the location, the internationalization, the primary activity of the firm, etc., which allows us to provide a more complete picture of the determinants of earnings quality in the hotel industry.

The paper is structured as follows. The next section provides a review of the previous literature and the development of our hypotheses; Section 3 presents the selection of the data, the definition and measurement of earnings quality, the explanatory variables and, finally, the research method. Section 4 presents the results. The last section provides our concluding remarks.

2. Literature and hypothesis

A majority of companies in the global economy are private and family-controlled firms (La Porta et al., 1999). In Spain, small and medium-sized enterprises (SMEs) represent 99% of businesses, employ 76.3% of workers and create 65% of value added (EC, 2012). Spain is characterized by the concentration of ownership in the hands of a few large stakeholders. According to La Porta et al. (1999), in Spain, the three largest shareholders own 51% of total shares, while in the US and the UK this proportion is 20% and 19%, respectively. Banks have traditionally a large presence as controlling shareholders in firms. The tourism industry shares these characteristics. Small companies are the typical business (only two companies are quoted) and access to financial resources is mainly determined by banks.

Market participants desire high-quality financial reporting because it reduces information asymmetries, increases overall transparency, and improves contracting (Watts and Zimmerman, 1986). High-quality financial reporting is approximated by earnings quality because earnings are the basis for the constructs and measures used by investors (Francis et al., 2004).

Most previous studies of earnings quality focus on listed companies and developed countries. Only recently research at the intersection of financial reporting quality and SME has attracted the attention of family firm scholars (e.g., Ball and Shivakumar, 2005; Burgstahler et al., 2006; Van Tendeloo and Vanstralaen, 2008; Katz, 2009; Givoly et al., 2010; Hope et al., 2013). The social role played by SME and family businesses is important for the development of economies, for emerging countries, and, especially, for the Spanish economy.

The earnings quality literature has focused on the determinants of earnings quality and its consequences (see Dechow et al., 2010 for a review). Recently, empirical research considering the quality of financial reporting in SME compared to large companies (e.g., Ball and Shivakumar, 2005; Burgstahler et al., 2006; Givoly et al., 2010; Hope et al., 2013) and the incentives to improve earnings quality has gained momentum (see Ali et al., 2007; Cascino et al., 2010). The literature documents that, in general, private companies experience lower earnings quality compared to public companies. Plausible explanations for lower earnings quality include the lower informational demand by stakeholders compared to larger companies (see Ball and Shivakumar, 2005; Burgstahler et al., 2006; Hope et al., 2013). The ownership structure, relationships between the controlling groups and other stakeholders, and concentration ownerships are extensively analyzed variables that influence earnings quality (see, e.g., Cascino et al., 2010).

Two competing theories are often proposed to explain the quality of accounting information in the case of SME (see, e.g. Jensen