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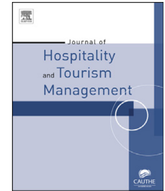

Precursors to the financial and strategic orientation of hotel property capital budgeting

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ABSTRACT

The purpose of this study is to develop and test a set of hypotheses concerned with exploring for precursors to the degree of emphasis hotel property General Managers attach to a financial versus strategic orientation in capital budgeting. Results are based on 200 survey responses from the General Managers of Australian and New Zealand hotels. The findings indicate that capital budgeting is more financially orientated than strategically oriented in hotel properties that adopt a management contract and also where the owner gets more involved in the capital budgeting process. No support is found for the hypothesised role of ego-trip hotel ownership, the age of a hotel property, a General Manager's number of years of experience, or public versus private hotel ownership. As an over-reliance on financial capital budgeting information can bias decision-makers against longer-term investment projects, it is conjectured that hotel capital budgeting may be somewhat sub-optimal in those hotels that adopt a management contract and which have a greater level of hotel owner involvement in the capital budgeting process.

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1. Introduction

The study of hotel capital budgeting is of unrelenting importance because the growth and maintenance of property values as well as higher levels of guest satisfaction and occupancy are contingent upon these investment decisions (Harper & Fiacchi, 1996). Despite extensive surveys of capital budgeting practice and use (e.g. Gitman & Vandenberg, 2000; Graham & Harvey, 2001; Ryan & Ryan, 2002), a limiting characteristic is that they have focused almost exclusively on financial measures (Ittner & Larcker, 2001). However, strategic measures are often used to assist in capital budgeting decision making (Moyer, McGuingan, & Kretlow, 2001) and a successful capital budgeting project does not necessarily have to be justifiable on purely financial grounds (Liberatore, Monahan, & Stout, 1992). In fact, there is evidence to suggest that use of financial capital budgeting measures alone can lead to the adoption of uneconomically viable projects (Cheng, Schulz, Luckett, & Booth, 2003).

In an effort to advance our appreciation of the relative emphasis hotel General Managers (GMs) attach to financial versus strategic measures in capital budgeting, this study has pursued the objective of investigating for precursors to the degree of emphasis GMs attach to a financial versus strategic orientation in hotel property capital budgeting. Motivation for this research comes from several sources. Firstly, Chen (2008) found that high product standardisation is associated with a greater financial orientation in capital budgeting decision making. Focusing on a specific industry represents an attempt to control for cross-industry variation in factors such as product standardisation. Secondly, the study of hotel capital budgeting is of major importance to hotels as they are punctuated by having a very high capital intensity (Collier & Gregory, 1995). Annual capital expenditures in U.S. hotels, for example, are reported to be 9.7% of gross revenue (ISHC, 2015, pp. 1–243). This demonstrates that capital budgeting decisions are likely to have a significant and long-lasting impact on a hotel property's direction, growth and ultimate performance. Thirdly, capital budgeting decision making tends to transpire within a context where the agency model is central (see Haka, 2007). This could be important because hotel owners are increasingly contracting hotel management companies to operate their properties (deRoos, 2010) in order, among other reasons, to generate higher profitability (Aissa & Goaied, 2016).

Guilding (2003, p. 180) notes with regard to management

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contracting that this “schism between ownership and management signifies that unlike the context of most capital budgeting, where investment decisions are made within the confines of a single hierarchical organisation, two distinct organisations are frequently involved in hotel investment decision making processes”. As GMs are typically responsible for the preparation of capital budgeting proposals (Denton, 1998) it is therefore the case than an added layer of complexity exists in hotels operating with a management contract. The GM, for example, acts as an agent to two principals, their owner and their management company meaning that there are potential agency problems at two distinct levels of the relationship – between the two principals and between each of them and their mutual agent, the GM (Hodari, Turner, & Sturman, 2017).

Whichever of the generally accepted main hotel operational forms are in operation, for example, the independent owner-operator, franchise or management contract (Gannon & Johnson, 1997), it can be particularly challenging for principals to limit the agency problem so they often turn to behavior-based control systems (Eisenhardt, 1989). This usually includes intervening in and therefore monitoring their agents' activities (Bergen, Dutta, & Walker, 1992) so as to mitigate their agents' information advantage and the potential for goal conflict. Involving themselves in the capital budgeting process is a way for principals to monitor and influence (Anderson & Oliver, 1987) their agent. This in turn can reduce the agent's propensity and/or ability to act counter to the owner's interests (Stump & Heide, 1996).

The main findings of this current study are that (1) management contract adoption, and (2) greater hotel owner involvement in the capital budgeting process each have a significant positive affect on the financial orientation of hotel property capital budgeting. No support is provided for the impact of ego-trip ownership, age of hotel property, experience of the GM, or public versus private hotel ownership on the financial versus strategic orientation of capital budgeting. These findings are illuminating if it is recognised that an over-reliance on financial capital budgeting information can bias decision-makers against certain investment projects (Ashford, Dyson, & Hodges, 1988; Cheung, 1993; Phelan, 1997). Specifically, they tend to accept too many short-lived projects and reject too many long-lived projects (Butler, Davis, Pike, & Sharp, 1991). This is one of the primary reasons why an approach to capital budgeting that incorporates both financial and strategic components is advocated (Gumbus, Lyons, & Bellhouse, 2003; Milis & Mercken, 2004). For example, it can encourage a relatively more balanced approach between the pursuit of long-term strategic objectives and shorter-term actions (Kaplan & Norton, 1996). In the long-run this shorter-term focus could act as a significant impediment in terms of its effect on such hotel property's growth, development, and ultimate performance.

The remainder of this paper is organised as follows. The next section outlines the literature which is pertinent to the development of this study's hypotheses. After this, the research method is presented, which is followed by measurement of the study's key variables. Next the study's results are documented, which are followed by a discussion of the findings. The final section provides a concluding commentary that includes implications, limitations and avenues for future research.

2. Literature review and hypothesis development

Porwal and Singhvi (1978), Kamath and Oberst (1992), and Chen (2008) have undertaken survey based enquiries relating to the issue of a financial versus nonfinancial approach to capital budgeting appraisal. While a large volume of research findings signify that one can be confident that the application of discounted cash flow capital budgeting techniques relative to other financially oriented techniques such as payback and accounting rate of return has increased substantially in the last 50 years (Haka, 2007), we actually know very little about whether the emphasis attached to financially oriented capital budgeting methods relative to other nonfinancial methods of capital budgeting has changed over the same time period. Furthermore, while a large body of capital budgeting literature exists that has focused on *which* appraisal techniques are being used (e.g. Arnold & Hatzopoulos, 2000), much less attention has been given to *how* these techniques are being used (Alkaraan & Northcott, 2007) and *how they might vary* across different contextual settings (Haka, 1987; Slagmulder, Bruggeman, & Van Wassenhove, 1995; Verbeeten, 2006). Given the calls for nonfinancial measures to be integrated into management accounting systems (Kaplan & Norton, 1992; Vaivio, 1999), this appears as surprising. Indeed it is notable that many empirical studies conclude that the application of financially oriented capital budgeting appraisal techniques do not always translate into better firm performance (see Haka, 2007).

A further limitation that arises in the extant literature relates to the fact that the degree of emphasis managers place on financial versus nonfinancial measures in capital budgeting has previously considered only the impact of national context (e.g. Carr & Harris, 2004; Carr & Tomkins, 1996, 1998; Shields, Chow, Kato, & Nakagawa, 1991). Studies which have documented differences in companies' emphasis on financial measures within same-country contexts suggest that these differences may be associated with other contextual variables, but there is little discussion of what these might be (e.g. Alkaraan & Northcott, 2006; Butler et al., 1991; Sandahl & Sjogren, 2003). Very little research has provided evidence regarding which contextual variables, other than country context, might be associated with these differences (Chen, 2008; Verbeeten, 2006). This current study seeks to address these limitations.

2.1. *Management contract adoption*

A management contract is a written agreement between an owner and operator where the operator is appointed to operate and manage a hotel in the name of, on behalf of, and for the account of the hotel owner (Schlup, 2004). The contract includes a description of the operator's remuneration fee determination (Turner & Guilding, 2010b). Although there is no single standardised management contract (Johnson, 1999), the typical arrangement enables a hotel owner to retain legal ownership of the hotel site, building, plant and equipment, furnishings and inventories, while the operator assumes responsibility for managing the hotel's day-to-day business (Guilding, 2003).

Drawing on the principles of agency theory, Guilding (2003) claims that management contract operated hotels will adopt more formalised capital budgeting procedures than hotels without a management contract because: (1) the propensity for capital budgeting information asymmetry arising between hotel owner and operator can be expected to cause hotel owners to implement relatively formalised procedures as part of a strategy designed to combat this challenge and also manage a potential for goal incongruence; and (2) the incremental dynamic arising in a management contract hotel structure will likely give rise to greater capital budgeting formalisation due to the need of the two parties to project themselves to one another in a formalised manner (prediction based on Brunsson, 1989; Langley, 1990, 1991). A capital budgeting process can be viewed as “formalised” where there is high “systematic study of issues” (Langley, 1990, p. 17), as

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