

Assets Sales and Earnings Management in the Hotel Industry

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Abstract

In this article we investigate the behavior in asset sales of publicly traded U.S. hotel firms in relation to earnings management. Asset disposition has been regarded as one of the most efficient methods for controlling accounting income. Given a heavy weight of fixed assets in the asset composition of hotel firms, it is sensible to presume that it would be easier for hotel managers to manage earnings by tuning the timing of asset sales if they decide to do so. In view of the unique characteristics of the hotel business –high vulnerability to economic circumstances and substantial fluctuations in property values, this paper will verify how hotels behave with respect to asset sales under disparate economic circumstances and if the behavior is related to an intention to manage earnings especially when the economy does not treat them favorably.

Keywords: *earnings management, asset sales, the U.S. hotel industry, economic conditions.*

In this article we investigate the behavior in asset sales of publicly traded U.S. hotel firms in relation to earnings management. After a struggle against worldwide economic recession over the past few years, the U.S. hotel industry shows indications of gradual recovery. Big buyers with flushing cash are waiting in line to invest in properties on the market and hotel firms also agree that this is a good timing to divest their properties (Hudson, 2010). Hyatt Hotels Corp. has put its 11 hotels on a list for sale and LaSalle Hotel Properties has gobbled up 6 hotels only in September, 2010. However, asset sales had steadily occurred during recent years of economic meltdown as well. Marriott reported cash proceeds of \$745 million and gains totaling \$40 million through asset dispositions in 2007, the amount up to 5.7% of its net income. If now, when the economy is rebounding, is the right time to whittle properties, then why hotels sell assets in tough times too? Though it is not straightforward to verify hotel managers' motivations for asset sales since a number of factors affect the decisions, we can presume the objective they try to achieve through asset sales in a bust period may differ from that in a booming period. As an answer to the question, this study proposes the possibility of earnings management.

Earnings management “occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the

underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers” (Healy and Wahlen, 1999). Among various ways to manage earnings, asset disposition has been regarded as one of the most efficient methods for controlling accounting income (Poitras, Wilkins, and Kwan, 2002). It is not only because managers can practice their discretion on the timing of sales but also because income from asset sales is reflected in the period of transactions (Bartov, 1993). A myriad of studies examined the use of asset sales as a way to manage earnings (Bartov, 1993; Poitras et al., 2002; Hermann, Inoue, and Thomas, 2003). They presented evidence in common conforming to their hypothesis that managers attempt to manage earnings by timing asset sales especially when they expect earnings decreases. Given a heavy weight of fixed assets in the asset composition of hotel firms, it is sensible to presume that it would be easier for hotel managers to manage earnings by tuning the timing of asset sales if they decide to do so. One of the major differences distinguishing this study from the former papers is a consideration of economic conditions. The hotel business has been regarded as more vulnerable to economic conditions than other industries (e.g. retailing or production) and property values have fluctuated accordingly (Skalpe, 2003). In view of the unique characteristics of the hotel business, this paper will verify how hotels behave with respect to asset sales under disparate economic circumstances and especially if the behavior has a relation to earnings management in poor economy.

Burgstahler and Dichev (1997) argued that firms manage earnings to prevent earnings decreases and losses. A number of studies revealed that companies with smoothly increasing earnings can lower their cost of capital (Bowen, DuCharm, and Shores, 1995; Botosan, 1997). One explanation is that a stable earnings trend can signal to investors firms’ potential to persist current earnings in the future (Hand, 1989). Therefore, we can predict a positive relation between income from asset sales and negative earnings changes, that is, the larger earnings decreases, the higher gains from asset sales.

H1: There exists a positive relationship between income from asset sales and negative earnings changes.

On the contrary, when the economy treats hotels favorably, managers can make divestiture decisions in the absence of earnings management intentions. They may sell assets to benefit from increases in property values or maintain them to enjoy rising revenue from operations. In other words, there would be no correlation between income from asset sales and earnings decreases or relatively a weak positive correlation at best. Accordingly, in addition to H1, this study proposes an asymmetric relation between income from asset sales and earnings decreases with respect to the economic situation.

H2: The positive correlation between income from asset sales and negative earnings changes is stronger in recession than in expansion.

The data span from 2000 to 2009, and are collected from COMPUSTAT database and 10-K reports.

$$SPPIV_t = \beta_0 + \beta_1 \Delta EARNING_t + \beta_2 DEBT_t + \beta_3 \Delta DEBT_t + \beta_4 GROWTH_t + \beta_5 PROFIT_t + \beta_6 SIZE_t + \beta_7 EC_t * EARNING_t + YRD + \varepsilon$$

SPPIV_t : Gains (losses) from sale of property, plant and equipment, and investment at time t

ΔEARNING_t : EBIT_t – EBIT_{t-1}, net of gains or losses associated with asset sales at time t

DEBT_t : Long term debt/ total asset at time t

ΔDEBT_t : The change in debt ratio (total debt/ total asset – total debt/ total asset) at time t

GROWTH_t : Tobin's q

PROFIT_t : Net income at time t

SIZE_t : Net sales at time t

EC_t : Economic condition (0= expansion, 1= contraction)

YRD: Year dummy

*SPPIV, ΔEARNING, PROFIT, and SIZE are scaled by total assets at time t-1

DEBT is to rule out the impact of the debt-covenant hypothesis, which is that managers likely adjust earnings to avoid the cost of debt covenant violation since most covenant terms are based on accounting numbers (Dechow, Sloan, and Sweeney 1996). Many studies used debt ratio as a proxy for the possibility of debt covenant violation (Bartov, 1993; Poitras et al., 2002; Hermann et al., 2003). Cash flow generation is another major purpose of asset sales (Redman and Tanner, 1989). Companies use proceeds to service debt or invest in future growth opportunities. ΔDEBT and GROWTH are included to control for these motivations. PROFIT and SIZE are to control a size effect since larger firms will engage in more various activities and have more reasons to sell assets (Poitras et al., 2002). To determine the effect of economic conditions, we included a dummy variable and an interaction term. Each year is assigned a number (0=expansion, 1=contraction) following the business cycle reference dates defined by the National Bureau of Economic Research. The fixed time effects OLS regression model will be used for analysis.

Findings of this paper would extend our insights into how hotels view and approach asset sales in dissimilar economic conditions. From a practical perspective, managers can get ideas on whether asset sales work as an earnings management tool, and investors can make better informed decisions by sharpening their understanding of earnings. In addition, as the first study on earnings management in the hotel industry, this paper will expand the hospitality literature by playing a role as a catalyst for further research regarding earnings management. Future research may explore other methods of earnings management used by hotels or examine the financial performance of hotel firms that engage in earnings management practices.

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