

# The relationship between persistence of abnormal earnings and usefulness of accounting information in hotel companies

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## Abstract

This study examines whether persistence of abnormal earnings affects book value of equity and earnings. According to Ohlson (Contemporary Accounting Res. (1995) 661–687) theoretical framework, a company's market value is a function of its book value of equity, earnings and other information. The persistence of abnormal earnings has a systematic relation with book value of equity and earnings. The persistence is measured using the first auto-correlation coefficient of abnormal earnings for two consecutive periods. This study intends to measure the persistence of abnormal earnings during 1993–2000 period for hotels and manufacturing companies. The results indicate that the persistence of abnormal earnings is higher for hotels than manufacturing companies and for hotels of first class than of other classes.

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*Keywords:* Persistence parameter of abnormal earnings; Model of abnormal earnings; The quality of accounting profit

## 1. Introduction

Policymakers are concerned with the economic aspects of tourism development, since a positive economic impact is necessary to generate income, job opportunities, business turnover, government taxes and foreign exchange earnings. This study empirically investigates whether hotels and manufacturing companies persistently obtain abnormal earnings. The accounting information provided to stakeholders in hotels to enable them to make accurate business decisions is important to ensure a continuous growth of hotels, especially as in Korea, the number of becoming bankrupt has increased in the prevailing economic climate.

The brand value of hotel companies is decided by the value of tangible and intangible assets. In Korea, almost all hotel companies, however, are not listed on securities market and their asset value is generally valued lower than companies so listed. This study intends to use the persistence of earnings as a proxy of asset value and evaluate the earnings of hotels and manufacturing

companies to suggest an indirect means of representing profits.

This study deals with a value evaluation problem based on Ohlson's (1995) model that explains the persistence of abnormal earnings. The importance of accounting information has received after Ohlson (1995) systematically analyzed former studies regarding residual income and abnormal earnings. Specifically, Ohlson (1995) suggested that corporate profit can be represented as a linear function of corporate assets and profit based on the assumption of a clean surplus relation between assets dividends and time series relation of surplus profits.

The 67% of users of accounting information, including financial analysts, credit analysts, and accountants, insist that they importantly consider earnings quality in economic decisions and the 91% of them believe that earnings quality is very useful to economic decision making (Bricker, Flaherty, & O'Connor, 1995; Kim & Choi, 1999). Financial analysts suggest that the persistence of abnormal earnings is very important to corporate decision making. Further, the persistence of abnormal earnings is positively related to earnings quality (Siegel, 1982). In Korea, the persistence of abnormal earnings is not generally analyzed by the users

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of accounting information. The persistence of earnings is positively related to the explanatory power of accounting profit toward stock prices (Kormendi & Lipe, 1987; Lipe, 1990; Ali & Zarowin, 1992).

This paper, it is thought will be of interest to researchers and practitioners alike in that, in hotels, the persistence of abnormal earnings will be useful information to represent the earning quality and provide a reasonable basis for decision making in merge, acquisitions and value evaluation.

## 2. Research background

The persistence of abnormal earnings represents the extent that present profit may be maintained in the future and indicates the status of corporate earnings.

Kormendi and Lipe (1987) modeled stock returns as a function of revisions in expectations of earnings, assuming that earnings can be represented by a univariate time-series, and then showed that the time-series properties of earnings will be an important factor in returns–earnings relationship. Easton and Zmijewski (1989) showed that the greater the impact of an earnings innovation on market participants' expectations of future earnings, i.e., the more persistent the time-series property of earnings, the larger the price change or the earnings response coefficients.

Other studies also use explicit theoretical models (Beaver, Lambert, & Ryan, 1987; Collins & Kothari, 1989; Inhoff & Lobo, 1984). The goal of this research is to increase understanding of how earnings and other accounting information are related to stock prices. Beaver et al. (1987) and Collins and Kothari (1989) find that unexpected earnings from year  $t + 1$  (as measured by the researcher) are correlated with returns from year  $t$ .

Inhoff (1992) examined security analysts' perceptions of companies' accounting quality in an effort to understand how differences in accounting quality are related to observable accounting characteristics. The results suggest accounting quality is systematically related to characteristics of earnings and several other accounting criteria. Also, the results provide evidence that earnings announcements from companies with relatively high perceived accounting quality produce larger response coefficients per unit of unexpected earnings than their 'low quality' counterparts. The empirical evidence suggests analysts' judgments of relative accounting quality differentiate companies in an economically relevant way.

Lipe (1990) examines the relation between stock returns and accounting earnings under the assumption that the market observes current-period information other than earnings. The returns–earnings relative depends on the relative ability of earnings versus alternative information to predict future earnings as

well as stability of earnings in a time-series. The parameters of yields were estimated for each of 145 companies. Simple and partial rank correlations show that the response coefficient is positively related to both predictability and stability across companies.

Anthony and Ramesh (1992) draw on research of a company's life cycle and business strategy to explain cross-sectional variation in earnings response coefficients. They argue that depending on information about a company's cash flow generating ability, the earnings response coefficients are predictably related to a company's stage in its life cycle.

More recently, Ohlson (1995) introduces a mean-reverting process for residual income that is in the spirit of competition eroding a company's sustained ability to earn supernormal earnings. By modeling residual income, instead of total income or changes in income, as an auto-regressive process Ohlson (1995) better captures the intuitive economic effect of product-market competition. Dechow, Hutton, and Sloan (1999) report evidence that supports the economic modeling of residual income as an auto-regressive process. The auto-regressive properties at the industry level have predictive power with respect to the persistence of earnings in future, but their objective was not to explicitly link stability of profits to earnings response coefficients.

Sloan (1996) show that stock prices reflect information about future earnings contained in the accrual and cash flow components of current earnings. The consistency of earnings performance is shown to depend on the relative magnitudes of cash and accrual components of earnings. The results indicate that earnings performance attributable to the accrual component of earnings exhibits lower stability than earnings performance attributable to the cash flow component of earnings. Bernard and Stober (1989) find no evidence that stock price respond in a systematic manner to the release of information about the cash flow and accrual components of earnings and propose that the information content of those two components of earnings may not be systematically different.

In predicting earnings to choose an optimal investment, financial analysts require high levels of predictability to ensure a high reliability of forecasts. As the predictability of earnings influences the quality of earnings, it is important to explain the predictability of earnings. If the intentional adjustment of earnings result in a high as predictability of earnings, this leads to a poor representation of the economic value of a company. In case of some companies, however, the continuity of earnings is positively related to the predictability of earnings and negatively related to the variability of earnings. Thus, the future predictability and continuity of earnings should be carefully examined to check whether they are altered by a past intentional adjustment of forecast earnings.

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