

FINANCIAL ASSESSMENT OF PERFORMANCE IN THE HOTEL INDUSTRY

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ABSTRACT: This paper aims to increase the knowledge on the financial methods of performance assessment used in the hotel industry, and is based on a review of empirical studies already performed. The reviewed articles allow us to conclude that the financial measures have a significant weight in the hotel industry performance assessment, but they should be complemented by other non-financial measures that consider the particularities of this industry, as well as the specific characteristics of hotel service. As this paper's main limitation we state the reduced number of studies found on the hotel industry, thus suggesting the need for further research on the performance assessment systems effectively used by the sector, as well as the identification of possible contingency variables that justify the use of specific measures in specific hotels. **Keywords:** financial assessment performance; management control; hotel industry.

RESUMEN: Este artículo tiene por objetivo reforzar el conocimiento sobre los métodos financieros de evaluación de la performance usados en la industria hostelera y está basado en una revisión de la literatura de estudios empíricos ya realizados. Los artículos revisados nos permiten concluir que los indicadores financieros tienen un peso significativo en la evaluación de la performance de la industria hostelera, pero deben ser complementados por otros indicadores no financieros que lleven en consideración las especificidades de esta industria, así como las características específicas del servicio hostelero. La principal limitación de este estudio es el reducido número de estudios dedicados a la industria hostelera, lo que sugiere la necesidad de otros estudios sobre los sistemas de evaluación de performance efectivamente usados en el sector, bien como la identificación de eventuales variables de contingencia que justifiquen el uso de indicadores específicos en hoteles específicos. **Palabras clave:** evaluación de la performance financiera, control de gestión, industria hostelera.

RESUMO: Este artigo pretende reforçar o conhecimento acerca dos métodos financeiros de avaliação da performance usados na indústria hoteleira, e está baseado numa revisão da literatura de estudos empíricos já realizados. Os artigos revistos permitem-nos concluir que os

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indicadores financeiros têm um peso significativo na avaliação da performance da indústria hoteleira, mas devem ser complementados por outros indicadores não financeiros que tomem em consideração as especificidades desta indústria, bem como as características específicas do serviço hoteleiro. A principal limitação deste estudo é o reduzido número de estudos dedicados à indústria hoteleira, o que sugere a necessidade de outros estudos sobre os sistemas de avaliação de performance efectivamente usados no sector, bem como a identificação de eventuais variáveis de contingência que justifiquem o uso de indicadores específicos em hotéis específicos. **Palavras chave:** avaliação da performance financeira, controlo de gestão, indústria hoteleira.

INTRODUCTION

This study intends to increase the knowledge on the financial methods of performance assessment used in the hotel industry, and is based on a review of empirical studies already performed. Performance assessment continues to be a current concern for researchers, given its importance for the short and long term survival and success of any organization (Anderson, Fish, Xia & Michello, 1999; Bol, 2011; Bol & Smith, 2011; Cardinal & Veen-Dirks, 2010; Cichello, Fee, Hadlock & Sonti, 2009; Chen, 2009; Gong, Li & Shin, 2011; Lau, Wong & Eggleton, 2008; Neumann, Roberts & Cauvin, 2010; Sholohin & Pike, 2009).

This subject is relevant for both the academic field and the business sector. It is important for the former because scientific information published on the hotel industry in Portugal is very scarce; and is important for the latter because it will supply information that may be of use for hotel managers in the future, informing them of possible courses to follow in order to improve the measures used for performance assessment in their hotels. After a general approach on the subject, the analysis focuses on the hotel industry, as it represents about 10% of the Portuguese Gross Domestic Product (INE 2010). Besides being a relevant sector with a strong and important role in the Portuguese economy, it is also one of the main areas where the Portuguese government has been focusing on lately, being also considered a fundamental sector to solve the financial crisis Portugal is currently facing.

This study is split into two main sections: in the first – corresponding to point 2 – we present the subject of financial assessment of performance; in the second section – corresponding to point 3 – we present the various performance assessment measures more suited to the particularities and needs of the hotel industry.

LITERATURE REVIEW

The need for performance assessment

The performance assessment systems are gaining an ever more relevant role in the development of any organization intending to survive an increase in global market competitiveness (Anderson *et al.*, 1999). For an effective and efficient management it is crucial that all company resources are well oriented and distributed. This goal cannot be met unless the manager has an actual knowledge of all the company's needs – in general and for every department – as well as all the existing resources (Chen, 2009). The manager can only have that actual knowledge if a performance assessment is made, so that he can efficiently and effectively allocate the resources owned by the company (Bol, 2011). But there is a problem: how to measure and how to perform that assessment, since an ill performed assessment can have worst consequences than not performing it at all (Gong *et al.*, 2011). In the last decades worldwide some authors (Kaplan & Norton, 1992, 1993, 1994, 1996a, 1996b, 1996c, 1997, 2001a, 2001b, 2001c, 2006, 2007; Lipe & Salterio, 2000; Roberts, Albright & Hibbets, 2004; Dilla & Steinbart, 2005; Budde, 2007; Johanson, Skoog, Backlund & Almqvist, 2006; Ittner, Larcker & Meyer, 2003; Pandey, 2005), have developed scientific studies with the cooperation of several companies, with the goal to create models that try to meet those needs.

According to studies performed in the last decade, this search for information on performance assessment happens with a ten year delay in Portugal (Ferreira, 2000; Melo, 2005; Pimentel & Major, 2007). According to Ferreira (2000), Portugal has enormous research opportunities in this area, given the fact that there is still a lot of uncovered information in all sectors of activity.

According to Neuman *et al.* (2010), and Cardinal, and Veen-Dirks (2010), performance assessment in organizations can be divided into two big areas: financial assessment of performance, and non-financial assessment. The financial assessment of performance is characterized by the use of indicators created by the financial area of the organization. The non-financial assessment of performance uses measures and indicators generated by other

areas, bearing in mind the objectives of the organization and its placement within the industry and market it belongs to (Cardinal & Veen-Dirks, 2010). In this study we will analyze in greater detail the financial assessment of performance – first globally, and later more specifically in the hotel industry.

FINANCIAL ASSESSMENT OF PERFORMANCE

One of management's main goals is decision making. And for that task to be performed coherently and as accurately as possible, it is necessary that each manager is fully aware of the company's reality and its surrounding environment (Bol & Smith, 2011). One of the oldest ways – and still very much in use – to assess an organization is to analyze the various measures of financial assessment of performance (Young & O'Byrne, 2000; Luft, 2009; Martin & Petty, 2000; Banker & Mashruwala, 2007; Corona, 2009).

Young and O'Byrne (2000) performed an intensive study on the various existing financial measures, having concluded that the majority of them were developed by consulting companies, with the aim to develop indicators that would satisfy the stockholders and managers' need to quantify the success or failure of the decisions made by the board. According to Young and O'Byrne (2000) the most mentioned performance assessment measures of recent decades are the following: EBIT (*Earnings Before Interests and Taxes*); EBITDA (*Earnings Before Interests, Taxes, Depreciation and Amortization*); EVA (*Economic Value Added*); RONA (*Return On Net Assets*); OCF (*Operating Cash Flow*). Young and O'Byrne (2000) have also concluded that due to management complexity and the diversity of financial performance assessment measures, there is no ideal indicator but rather a set of indicators that should be analyzed simultaneously. The various performance assessment measures have advantages and disadvantages, and the crossing of those measures and simultaneous use improves their performance and effectiveness (Young & O'Byrne, 2000).

Brigham and Houston (2003) also consider financial ratios to be an excellent tool, together with the financial statements, to

help assess and classify companies. Following this line of thought, several years later Luft (2009) concluded that the choice of financial performance assessment measures must take into account two factors: the future results intended by the company and their inherent risks. Luft (2009) also highlights the importance of using and combining different indicators, because as each indicator has advantages and disadvantages when the information resulting from each indicator is crossed the global result produces a richer and more balanced information, giving the manager more reliable information.

According to Tuomela (2005), the financial performance assessment measures have some advantages when compared to the non-financial performance assessment measures, namely:

- The information necessary to calculate those measures is easy to access, since it's available on the companies' financial statements;
- The necessary calculations to obtain the value of each indicator are simple, which also makes them easier to interpret;
- Because the indicators have a normalized information source – the values in the financial statements – this makes it easy to compare them on different levels: we can compare values from different periods, and from different companies from the same or from other industries.

However, the reviewed literature also identifies some disadvantages regarding the exclusive use of financial performance assessment measures (Martin & Petty, 2000):

- In many cases the values presented in the financial reports are not the actual cash flows, and the classification of certain operations may vary from company to company. This gives origin to different results and profits depending on the way they are registered, reflecting an inconsistency in the values and making them unsuited for comparing the company's performance;
- The values showed in the accounts do not reflect the risks related with the company's activity nor the opportunity cost for capital;
- Another problem mentioned is the fact that the values in the financial statements do not reflect the changes in value of monetary goods.

These critics lead other authors to defend the need to complement the financial assessment of performance with other non-financial measures (Young & O'Byrne, 2000; Banker & Mashruwala, 2007; Van der Geer, Van Tuijl & Rutte, 2009; Corona, 2009). According to Young and O'Byrne (2000), several organizations complemented the financial measures of performance assessment with others that provide better information for decision making, considering the goals of the organization and the strategies it intends to follow. Young and O'Byrne (2000) also highlight the importance of non-financial measures of performance assessment for those companies where personnel costs are a significant part of total costs, such as in the hotel industry.

Banker and Mashruwala (2007) and Van der Geer *et al.* (2009) also mention the importance of non-financial measures as a way to compensate the already mentioned disadvantages of exclusively using financial indicators. These authors also say that measures such as co-worker and client satisfaction, or competition are extremely relevant indicators when analyzing a company in the medium and long run.

According to Corona (2009), parameters such as client satisfaction or product quality are starting to be considered as being almost as important as the intangible assets, and therefore this author defends they should be accounted as such in the future.

Despite there being an increase in the number of authors that defend the joint use of both financial and non-financial indicators, none defends not using financial indicators. Even not being perfect they are extremely relevant, and for the time being irreplaceable.

Van der Geer *et al.* (2009) highlights the importance of financial statements, as mentioned earlier, not only as a source for the creation of financial measures, but also because they allow us to see the recent past and to plan future actions. Comparing the recent past with previous data allows the anticipation of future events and market conditions, thus improving in both cases the performance of the company (Van der Geer *et al.*, 2009).

FINANCIAL ASSESSMENT OF PERFORMANCE IN THE HOTEL INDUSTRY

We found five studies on financial assessment of performance in the hotel industry (Anderson *et al.*, 1999; Phillips, 1999; Jagels & Coltman, 2004; Chen, 2009; Jorge, 2010). Anderson *et al.* (1999) and Chen (2009) highlight the importance of performance assessment for the short and long term survival and success of any hotel. Phillips (1999), besides confirming the conclusions of the previously mentioned authors, underlines the fact that an ill performed assessment may significantly harm the competitiveness and success of a hotel. According to Jagels and Coltman (2004), the financial measures are rather diversified and must be selected depending on the characteristics of the organization under study. These measures should not be analyzed separately but according to an evolutionary perspective, comparing them to a previously set pattern. Jagels and Coltman (2004) conclude that in the hotel industry, the most used performance assessment measures should be divided into five categories: liquidity ratios, profitability ratios, financial leveraging ratios, activity ratios and operation ratios.

After analyzing several studies on the financial assessment of performance in the hotel industry, and considering his professional experience in this sector, Jorge (2010) presents the most used ratios within the five categories proposed by Jagels and Coltman (2004). Table 1 presents the four liquidity ratios proposed by Jorge (2010) for the hotel industry: general liquidity, immediate liquidity, credit card receivings, and liquidity safety period.

Table 1 – Liquidity Ratios

Ratio	Formula
General Liquidity	Current Assets / Current Liabilities
Immediate Liquidity	(Bank Deposits + Cash + Negotiable Securities) / Current Liabilities
Credit Card Receivings	Average of credit card receivings / Total credit card receivings
Liquidity Safety Period (days)	(Current Assets – Inventory) / Operating Costs (daily)

Source: Jorge (2010)

Table 2 presents the four profitability ratios proposed by Jorge (2010) for the hotel industry: return on equity, return on assets, operating return on sales, price/earnings.

Tabela 2 – Profitability Ratios

Ratio	Formula
Return on Equity (%)	Net Profit / Equity
Return on Assets (%)	Net Operating Profit / Assets
Operating Return on Sales (%)	Net Operating Profit / Sales Volume
Price/earnings	Share price / Share profit

Source: Jorge (2010)

Table 3 presents the four financial leveraging ratios proposed by Jorge (2010) for the hotel industry: borrowing level, financial expenses coverage level, borrowing structure, debt collection period.

Table 3 – Financial Leveraging Ratios

Ratio	Formula
Borrowing	Debt Capital / Total Equity
Financial Expenses Coverage	Gross Operating Surplus / Financial Expenses
Borrowing Structure	Short Term Debt Capital / Debt Capital
Debt Collection Period (years)	Loans Receivable / Self-financing

Source: Jorge (2010)

Table 4 presents the four activity ratios proposed by Jorge (2010) for the hotel industry – the last ones exclusively financial: inventory turnover, turnover on assets, average collection period, average payment period.

Table 4 – Activity Ratios

Ratio	Formula
Inventory Turnover	Sales Volume / Average Inventory
Turnover on Assets	Sales Volume / Average Assets
Average Collection Period (days)	[Average Receivables Balance / Sales and Service Repayments x (1+t)] x 365
Average Payment Period (days)	[Average Suppliers Balance / Purchases and Supplies x (1+t)] x 365

Source: Jorge (2010)

Jorge (2010) considers the financial ratios above have to be complemented in the hotel industry by other measures specific to this industry. Table 5 presents the five operating ratios proposed by Jorge (2010) for the hotel industry. The first two ratios assess hotel industry performance in the food and beverages subsector: staff average per client, monthly revenues per sitting place. The last three indicators assess the hotel industry performance in the lodgings subsector: average revenues per room, occupation rate, revenues per available room.

Table 5 – Operating Ratios

Ratio	Formula
Food and Beverages: Staff Average per Client	Customers Served / Quantity of Staff Members
Food and Beverage: Monthly Revenues per Sitting Place	Restaurant Monthly Revenues / Number of Sitting Places
Average Revenues per Room	Total of Room Revenues / Number of Occupied Rooms
Occupation Rate	Occupied Rooms / Available Rooms
Revenues per Available Room	Total Room Revenues / Total of Available Rooms

Source: Jorge (2010)

Jorge (2010) also stresses that those in charge of performance assessment should be employees of the organization – with a full knowledge of the various existing performance assessment technics, measures and theoretic models known up to the present day – people with a complete knowledge of the organization and its business. Many times, when the companies use external consultants the latter point is crippled in most cases. The hotel and tourism industry is a very specific industry, which makes it all the more relevant the adaptation of the performance assessment theories and models to its needs (Jorge, 2010).

CONCLUSIONS

The present study intends to increase the knowledge on the financial methods of performance assessment used in the hotel industry, and it was based on a review of empirical studies already performed. This work allowed us to conclude that performance

assessment is currently a crucial factor for the survival of any organization in general, including the hotel industry. The reviewed articles led us to conclude that the financial measures have a lot of weight in performance assessment in the hotel industry. However, these measures should be complemented by other non-financial measures that consider the particularities of this sector, as well as the specific characteristics of hotel service. As main limitation of this paper we state the reduced number of studies found on the hotel industry, which suggests a need for further research on the performance assessment systems effectively used by the hotel industry, as well as the identification of possible contingency variables justifying the use of certain measures in certain hotels.

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