

**THE FRANCHISING EFFECT ON EARNINGS
MANAGEMENT: EVIDENCES FROM LODGING AND
RESTAURANT INDUSTRY**

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Dissertation submitted as partial requirement for the conferral of
Master's in management

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October 2019

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Acknowledgements

To all my family and friends that support this journey, thank you for all the patience and tolerance around my absence. For Francisca, in particular, thank you very much for the essential support in the final stage of this dissertation and for showing me always on first-hand how *crazy* things can happen.

To Diogo, no word could thank you enough for the support, patience, motivation, and truly care about my personal ambitions. This path without you would be so much harder.

To my work colleagues, thank you for the support and encouragement. And not left behind, thank you for letting me *breathe* a little more during this last stage and, by doing that, allowing this to be possible.

To my supervisor, Paulo Jorge Dias, and co-supervisor, Daniela Penela, thank you for the patience and the knowledge shared.

My truly thank you for all of you.

Resumo

Earnings management revelou-se uma prática recorrente em diversas empresas. Nesse sentido, a literatura tem direcionado os seus esforços para estabelecer determinantes que expliquem a prática de *earnings management* em variados setores. Embora a prática de *earnings management* tenha sido extensivamente estudado, apenas literatura recente sobre *earnings management* em restaurantes franchisados expôs o *franchising* como uma característica das empresas que induz a diferenças significativas no comportamento de *earnings management*. Contudo, a investigação realizada sobre esta temática, na sua relação específica com o *franchising*, é bastante restrita. O objetivo primordial da presente dissertação consiste em analisar o efeito do grau de *franchising* ($DOF_{i,t}$) no *earnings management* e comparar o seu impacto no sector dos restaurantes e do alojamento. A principal conclusão aponta para a existência de uma relação positiva entre o grau de *franchising* e o *earnings management* ($DACC_{it}$), estimado através do modelo *Modified Jones*. Adicionalmente, foi verificado que o efeito do ($DOF_{i,t}$) no *earnings management* é mais fraco para as empresas de restauração quando comparado às empresas de alojamento.

Palavras-chaves: Earnings Management; Franchising; Empresas Americanas de Hospedagem; Empresas Americanas de Restaurantes.

JEL Classification: Contabilidade; Modelização Econométrica.

Abstract

Earnings management behavior has become predominant within several firms. With this regard, literature has attempt to place earnings management determinants in many industries. Although earnings management had been extensively studied, only recent literature regarding earnings management in franchise restaurants had expose franchising as a firm characteristic that induce significant differences in the behavior of earnings management. However, very few researches have been performed concerning the relationship of earnings management in franchising field. The main purpose of this research was to analyze the effect of degree of franchising ($DOF_{i,t}$) on earnings management and compare the impact on restaurant and lodging industries. Main finding pointed that exist a positive relationship between the degree of franchising and earnings management ($DACC_{it}$), estimated though Modified Jones model. Further, the effect of ($DOF_{i,t}$) on earnings management is weaker for restaurant firms when compared to lodging firms.

Keywords: Earnings Management; Franchising; American lodging firms; American restaurant firms.

JEL Classification: Accounting; Econometric modelling.

Executive Summary

The present dissertation has the objective to study the relationship between earnings management and the degree of franchising, as well as compare the effect on lodging and restaurant industry.

Earnings management is a practice conducted, in general, by managers and executives that consist in manage the companies' earnings with the intention of reach specific objectives in terms of the results reported in financial statements. This behavior had spread along industries and it is, currently, a common practice. This matter has raised preoccupation along investors and academic, that aim to explore this topic in order to better understand the behavior.

The public scandals of Boston Chicken and Krispy Kreme regarding earnings management raised serious concern around the subject of earnings management and literature follow the track to better understand the subject. An interesting characteristic around these scandals seemed to be missed in research concerning this topic – both companies had in place franchising agreements.

Franchising business operation is characterized by a franchisor that licenses its know-how, procedures, intellectual property, use of its business model, brand, and rights to sell its branded products and services to a franchisee that, in return, pays a determine fees and agrees to comply with certain obligations.

To assess if there is any positive relation between earnings management and the degree of franchising ($DOF_{i,t}$), a sample of lodging and restaurant firms were selected to perform an ordinary least square regression and, subsequently, was conducted a comparation between both sectors evidences. The sample is composed by all companies within NYSE (former AMEX) and NASDAQ markets, under standard industry classification (SIC) code 5812 and 7011, and which financial data were available at Bloomberg database. The financial data were derived from each company's annual 10-K¹ reports and from Bloomberg database.

The sample for lodging and restaurant sectors totalized, respectively, 15 firms and 45 firms, being 9 firms and 30 firms performing franchise agreements. To estimate the dependent variable for earnings management ($DOF_{i,t}$), was perform Modified Jones

¹ Annual 10-K is a comprehensive summary report of company's performance that must be submitted annually to the Securities and Exchange Commission.

model, since prevented multicollinearity issues within regression, considering the set of explicative variables in use.

The explanatory variable under analysis is the degree of franchising ($DOF_{i,t}$) and this stands for the total amount of properties under franchising agreements divided by the total amount of properties within a firm. A set of control variables was selected made based on data availability and in line with previous research. Additionally, was performed an initial assignment on the individual significance for each independent variable, supporting the choice of which one. The ordinary squared model performed relates the degree of franchising ($DOF_{i,t}$) and the set of control variables with earnings management dependent variable, discretionary accruals ($DACC_{it}$).

In accordance with expected results, ($DOF_{i,t}$) has a positive impact and significance on earnings management and was verified that this impact is more prevalent in lodging sector, when compare to restaurant sector.

This dissertation expects to leverage the matter of earnings management within franchising field and enhance the discussion around the topic. Although the recent enforce to fill the gap in this specific matter, further research regarding this relationship should be performed. It may also be desirable to explore other factors that are impacting earnings management when interacting with degree of franchising, such as industries specificities or firms' characteristics.

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1. Introduction

1.1. Framework

For financial performance acknowledge, accounting reports are widely used as the available source of information. Earnings management is a practice conducted, normally, by managers and executives that consist in manage the companies' earnings with the intention of reach specific objectives in terms of the results reported in financial statements. There are various motives that can be behind earnings management, such as, attract investment opportunities, achieve profit indicators or even, accomplish performance bonus. Cimini (2015) consider earning management as being an attempt from insiders to manipulate earnings in opposition to outsiders' interest.

As matter of fact, earnings management become extensively used and raised preoccupation between investors as credibility of earnings management were put into question. In fact, massive shareholder losses, in the early 21th, arise by one of the most infamous examples of earnings manipulation proved that this subject is no fun. Enron and WorldCome were caught is used of fake accounting entries to overestimate their revenue and accused of accounting fraud (Gim, Choi, & Jang, 2019). Both corporate giants ended to demise.

The Scandal of Boston Chicken in 1997 is the proof that restaurants firms are no exception to the practice of manipulating earnings. Was found out that the franchisees of Boston Chicken were forced to borrow money from the company to create the image of a rapidly growing franchise business as the repayments were revenue. Another case of earnings manipulation in restaurants was in the American donut sector, Krispy Kreme was found guilty in court and had to restate its earnings in fiscal year 2001, 2002 and 2003 for shipping double orders to its franchisees.

These early century cases exposed an unseen correlation between earnings management and franchising. Franchising operating model can be adopted by a corporation as a strategy for business expansion. In behalf of a franchising agreement, a franchisor licenses its know-how, procedures, intellectual property, use of its business model, brand, and rights to sell its branded products and services to a franchisee. In return the franchisee pays determine fees and agrees to comply with certain obligations.

In fact, franchising appears as a strong possible performer of these practices since one of their main objectives is to attract investors to franchising business. In 2019, Gim et al. investigated whether franchising firm characteristic, of restaurant firms, causes any meaningful differences in the earnings management behavior.

Research by Brickey and Dark (1987) and Hsu, Jang, & Canter (2010) has provided evidences that the effects of franchising, which has experienced worldwide growth, have been notably strong for the hospitality sector. In fact, quick service restaurant presented the biggest market share in terms of output distribution in franchising sector, during 2018. According to IHS Economics (2018), quick service restaurant accounted to 34% of output distribution in franchising sector, followed by business service (13%), lodging and table/full service restaurant (both with 10%).

Meek, Davis-Sramek, Baucus, & Germain (2011) pointed out that that in recent decades, there has been notice an accelerated growth in franchising business model in many manufacturing and service industries. In US, the franchise business index² (“FBI”) has been growing continuously since 2010, reaching a 124.3 FBI at November 2017³.

In order to expand business operation, corporations must encourage prospective franchisee that the franchise system, in the long-term will remain profitable and that is a good investment. Additionally, asymmetric information is a predominant factor between franchisors and potential franchisees, which, typically, represent an environmental condition that can lead to earnings management (Lapiedra-Alcamí, Reig-Fabado, & Rueda-Armengot, 2014)

1.2. Objectives

According to Gim et al. (2019), franchise restaurants engage more actively in earnings management during the growth stage which implies that the main supplier of capital for franchise restaurants, that potential franchisees, can be easily exposed to a franchisor’s misleading accounting information.

² The FBI combines indicators of the growth or decline of industries where franchise activity has historically been concentrated with measures of the demand for franchise business services and the general business environment. The components of the index are (i) employment in franchise businesses (ADP), (ii) number of self employed (BLS), (iii) unemployment rate (BLS), (iv) retail sales of franchise-intensive industries (Census Bureau), (v) small business optimism index (NFIB), (vi) small business credit conditions index (NFIB).

³ Last data available

The main objective of this thesis was to verify whether or not franchising, as a characteristic of a firm, impacts earnings management behaviors in the restaurant and lodging sector.

One of the objectives of this thesis is assess the impact of degree of franchising ($DOF_{i,t}$) on earnings management within restaurant sector to the lodging sector. This parallel seem necessary since lodging and restaurant industries, even though the irrefutable similarities, differ in specific characteristics that can potentiate not comparable behaviors around earnings management.

Lodging industry is characterized by high values of fixed tangible assets that requires proper financing methods to leverage that need. Considering the unique capital raising behavior of franchise lodging companies, heterogenous behaviors around earning management are expected. In this regard, distinguish sources of potential heterogeneity would enable for a deeper understanding of earnings management within restaurant and lodging field.

Even though, the main objective of this dissertation is to investigate whether there is any positive relation between $DOF_{i,t}$ and earnings management dependent variable ($DACC_{i,t}$). The results could have relevant implications to understand better which characteristics potentiate this behavior allowing regulatory forces to act in advantage or to better trigger inspections and audits.

2. Literature review

2.1. Franchising path

Franchising has significantly affected the worldwide economy, contributing to an exponential growth of several economic groups. The Asia-Pacific region, for example, has experienced particularly strong growth within food services, in recent years, leveraged by franchises companies within the territory. In India, namely, the foodservice industry has experienced strong double-digit growth consistently over the last five years (MarketLine, 2017). In China, the industry has experienced strong growth in recent years as consumers increase spending, especially as Western brands continue to dominate the industry. However, these players have needed to adapt to the consumer tastes, with KFC and McDonalds both adapting their western menus for the Chinese market. This growth conducted by large multinational companies has largely been due to changing consumer lifestyles and consumption habits, as well as rising disposable incomes (MarketLine, 2017).

The franchising business model has been well known for being one of the favorite operating models to penetrate new markets, especially the ones with specific characteristics and very different culture habits, like it is to move from Western to East. But, why is the franchising model so successful? Why shareholders choose in the early days this business model to expand? Why investors choose to invest in franchise companies? Even though the issues raised have been studied and investigated over the years by academics, franchising business model is such a complex and dynamic configuration that still exits unexploited themes and behaviors around this operating model.

In franchising business model, the franchisor grants a license, servicemark and trademark along with the provision of advice and assistance for organize, merchandise and manage the business as a part of a long term relationship between franchisor and franchisee (Caves and Murphy, 1976; Brickley and Dark , 1987; Lafontaine, 1992).

The first research conducted in the franchising field focused on, specifically, building theoretical foundations based on resource scarcity theory (Dant, Paswan, & Stanworth, 1996; Kaufmann & Dant, 1996) and agency theory (Lafontaine & Kaufmann, 1994; Shane, 1998). The early research conducted in franchising spectrums also focused on

motivation factors of franchising (Hackett, 1976; Desai, 1997) and the relationship between franchisees and franchisors (Housden, 1984; Dnes, 1993).

As explained by Oxenfeldt and Kelly (1969), companies saw franchise option as a way to access capital to business expansion. Related to this matter is Myers and Majluf (1984) research known as pecking order theory suggests that *firms rely on internally generated cash at low growth levels, but as growth levels increase internal cash is exhausted and firms must turn to the credit market for debt financing before finally moving on to equity financing - the costliest form of external capital*. In this regard, companies seek to make the most of growth opportunities available, in view of firms within the fast-growing stage have avid appetites for liquidity, i.e. cash (Bygrave and Timmons, 1992; Binks and Ennew, 1996).

By looking for the market behavior, scholars predicted that would existed a relation between franchising and financial performance afterward the wide and successful dispersion of this business model. In the beginning of the new millennial, research conducted have proven the effect of franchising on financial performance and firm value, namely, on franchising firm's chain revenue (Sorenson & Sørensen, 2001) and tested the effect of franchising on financial growth through restaurant companies (Y. S. Roh, 2002). In 2009, research conducted within restaurant sector have demonstrated that franchising business model has a positive effect on restaurant firms' financial performance and firm value, despite the fact scholars have debated whether an inverted U-shaped relationship exists between franchising proportion and financial performance (Jane, Hsu & Jang, 2009; Koh, Lee, & Boo, 2009). Although academics have discussed whether an inverted U-shaped relationship exists between the proportion of franchising within a group and the financial performance, preceding research have exposed its positive effect on restaurant companies' financial performance and the firm value (Hsu & Jang, 2009; Koh et al., 2009).

However, the study by Hsu and Jang (2009) indicated that the presence of an inverted U-shape relationship indicated significance, whereas Koh et al (2009) did not find this relationship to be significant. Therefore, notwithstanding this considerable interest in franchising, few studies have investigated its financial effect in the lodging industry (Park & Jang, 2018).

Franchising is largely seen has an opportunity for growth and expansion. Notwithstanding, and according to Khan & Akhtar (2018) when companies pursue

growth opportunities extensively, their capability to create cash internally usually cannot match the need for liquidity for growth path. When a company cannot generate internally the amount of capital needed, inevitably, it's demanded to turn to external market, this is, attracting investment or incur in borrowing.

Growth opportunities can exist, but when is essential to raise capital, franchise restaurants don't always observe the conventional pecking order theory (Park & Jang, 2017). The franchise income under deficits is not only important as a supplement to the conventional sources of capital but also potentially substitutes them (Choi, Lee, Choi, & Sun, 2018; Park & Jang, 2017). Strictly speaking, franchise and non-franchise restaurants have different types of main sources in capital growth, and that happens because the main source of capital growth for franchise restaurants firms are the potential franchisees.

Franchisors normally get franchise contracts with great deal of bargaining power, which concede them to earn at the expense of franchisees (Williams, 1999). Vast research exposed that franchisees are in a very hard position to make accurate and knowledgeable decisions considering a lack of equitable and reliable information about franchise systems in particular (Lapiedra-Alcamí et al., 2014). This expose a natural market factor called information asymmetry that happen when one party of an economic operation possesses greater knowledge and information than the other party.

Mature firms are easier to observe and monitor than fast-growing firms, assumed by the contacting theory (Myers, 1977). This happens because of the knowledge that high growth firms' partners have about the future cash-generating opportunities that are impossible to observe just from the firm's existing assets (Smith and Watts, 1992). There is no way possible to the current control system sufficiently track firms beyond the current scale of operations, since that firms, in the majority, are characterized by its huge levels of future investment opportunities and low levels of assets-in-place (Smith & Watts, 1992; Baber et al., 1996). Therefore, wide information asymmetry is created by the high growth opportunities, a key environmental condition that makes the difference in managers earnings management behaviors. Core, (2001) researched that high growth opportunities lead to increased levels of asymmetry in information between management team and board members and outsiders.

Yet, accusations regarding the provision of misleading or even fraudulent information to prospective franchisees have been conduct against franchisors to appeal more income from franchisees (Theodore, 2017). All these considerations raise serious concerns

around information asymmetries between franchisors and expected franchisees. Regarding this matter, Federal Trade Commission (FTC) proclaimed Item 21 that requires that all franchisors disclose financial statements audited to validate prospective franchise buyers over the process of pre-sale disclosure. This action enhanced the severity of information asymmetries in franchisor and franchisee relationship, disclosing, on more time, the imbalanced positions of this business strategy.

On the other hand, non-franchise restaurants have no alternative than follow the financing path, when without access to low-cost capital, proposed by pecking order theory to finance growth opportunities (E. Y. Roh, Tarasi, & Popa, 2013). When non-franchise restaurants walk through financing path, normally, have no choice than rely on debt financing.

In turn, the main capital suppliers for non-franchise restaurant firms are creditors which are considered to be more knowledgeable and experienced regarding scrutinizing firms (Graham, Li, & Qiu, 2008). Accordingly, creditor's expertise could easily mitigated the information gap between creditors and managers (Gul & Goodwin, 2010).

Consequently, for borrowing favorable terms and conditions in order to increase capital, companies with expanded growth opportunities are more likely to manipulate their earnings positively so that they can create the image of favorable investment opportunity which save interest and principal payments. (Sincerre, Sampaio, Famá, & Dos Santos, 2016; Hong, 2017).

However, there are other things that can make a huge difference in the degree of earnings management without being the firms' growth. Opportunities could be different between franchise and non-franchise business assets, namely specifically franchise restaurants firms (Gim et al., 2019).

This conduce again for the positive relation between growth opportunities, degree of earnings management and information asymmetry. Other important topic is that, not just growth opportunities are directly related with the degree of earnings management, as present above, fast growing firms generally are in the begging of its activity, presenting less data available for market and investors analyses, conducting to higher hypothesis of information asymmetry.

Hsu & Jang, (2009), Koh, Lee, & Boo, (2009) and Roh & Choi, (2010) also investigated the franchising firm's profitability and firm's value in restaurant field. Although, not all restaurants have the same prerequisite conditions. Indeed, in the restaurant field, we have

two differ business models with very different characteristics – franchise and non-franchise – and this condition must be considered when analyzing earnings management. In case of franchisees, companies’ pay franchise fees that represents a source of capital solely available to franchise firms, like restaurants, which potentiate earnings management practice (Gim et al., 2019).

2.2. Reporting framework

FASB (1984) defended that the primary purpose of financial statement is to express financial information to outside of stakeholders’ boundaries in time and in a reliable matter. The primary source of data concerning a firm’s financial position and performance, publicly available, are the financial reports. In order to proceed a company’s valuation and conduce highly influential decision-making is necessary a sustainable data basis. The financial reports provide very valuable information that is required for decisions with high responsibility and by that, the veracity of that time of data is major in every sense. Market players aim for high-quality financial reports since it boosts overall transparency which conduce to a reduction on information asymmetries and enhance contracting opportunities (Watts and Zimmerman, 1986).

Is this field, Francis, LaFond, Olsson, & Schipper (2004) and Francis et al. (2004) defended that earnings figure in the most important indicator. Francis et al. (2004) defended “*that high-quality financial reporting is approximated by earnings quality because earnings are the basis for the constructs and measures used by investors*”.

Creditors also hold on earnings information to analyze companies’ financial health and viability before reaching a decision regarding leading (Ge and Kim, 2009). The businesses’ positive earnings figure have a substantial importance, especially publicly traded firms (Parte-Esteban & Ferrer García, 2014). Earnings information in also used by shareholders to monitor the operational performance of companies and to make stock trading decisions (Cupertino, Martinez, & da Costa, 2015).

2.3. Earnings management path

The quality of accounting information and, consequently, the wealth of stakeholders, have been threaten by abuses in accounting flexibility with the objective to manipulate reported

earnings (Gim et al., 2019). As a matter of that, earning management have gained popularity across managers who use it as a common practice to manipulate their earnings increasing concern around this matter (Chan, Jegadeesh, & Sougiannis, 2004).

Managers often have same flexibility in choosing accounting principles regarding GAAP (Generally Accepted Accounting Principles) when preparing financial reports Amat, O., Blake, J., Dowds, J.,1998). Earnings management appear as a *“reasonable and legal management decision making and reporting intended to achieve stable and predictable financial results”*. (McKee, 2005). Notwithstanding, in case of an American company, earnings management is practiced within the GAAP boundaries, financial fraud in conducted outside of GAAPS field (Perols & Lougee, 2011).

Earnings management arise when managers create financial statements taking advantage of the flexible nature of determine accounting principles in order to, more favorably, reflect a firm’s financial performance than a more conservative perspective would (Healy and Wahlen, 1999; Braam et al., 2015).

Managers have diverse reasons to manage earning. Gaver et al. (1995) recorded that managers sick to achieve managerial remuneration packages because, according to Singh (2008), exceedingly compensation contracts are based in companies’ earnings and financial results to calculate or achieve the cash bonus or stock options. Research have already demonstrated evidences that managers in firms with different sizes have the opportunity of altering earning figure whether there is a public firm or a private firm (Burgstahler, Hail, & Leuz, 2006; Coppens & Peek, 2005). Moreover, manipulation of accounting earnings in a well-known practice between managers to influence investors’ perception of business health and, thereby, attract low-cost external capital successfully. The CEO is also a key figure in the preparation and supervision of financial information and therefore financial reports. The research also paid special attention to the boards (and CEOs) in the monitoring role that they have in influence financial reports and, consequently, the quality of earnings. In 2011, Turner & Guilding, motivated by earnings figure importance, explored the motivations and incentives of hotel shareholders to engage in earnings management taking use of a specific accounting item, the alternative of expensing or capitalization of asset related expenditures. This research was conducting precisely in the lodging sector, and by that, we can expose the emphasis that this topic has in such a specific sector.

The first research conducted regarding earnings management mainly covered the identification of managerial incentives to inflate corporations' earnings. It were identify various motives in the early literature, namely, to achieve personal gains (Gaver et al., 1995) raising capital (Teoh et al., 1998) in order to not incur in debt violations (DeFond and Jiambalvo, 1994), and lastly, meet or outstand analyst and management forecast (Cohen, Dey, & Lys, 2008). Managers have also been known to manipulate accounting earnings (He & Yang, 2014), which results in questioning the credibility of earnings information.

Other important point is, since firms with high market-diversification presents critical organizational complexity, there are increased companies' information asymmetry, which consequently alter managers' earnings management behavior (Ajay and Madhumathi, 2015). By that, we can conclude that a companies' degree of market diversification is directly associated to earnings management. In other way, firms with low degree of market-diversification have, consequently, less exposure to asymmetric information, having less incentives to manage earnings. Ferramosca and Allegrini (2018) defended that family-owned companies have less incentives to manage earnings because "*are less sensitive to leverage-related matters such as debt covenant violations*".

Earnings management is one of the most broadly investigated topic in the financial accounting research as the trend of managers playing with account reports, specially, reported earnings, has it become a diffuse practice.

It is easy to extrapolate the relation between earnings management and franchising, since the second one represents a way of capture companies' investment with external capital that need to be attract to a franchising contract, and which tools have they to make decisions about firm's financial position and performance? The most broadly used is financial reports.

2.4. Franchise restaurant and earnings management framework

Although the latter effort to examine different business models and organizational settings, just one research was conducted in way to relate franchising business model, in the restaurant sector, with earnings management behavior. The study of Gim et al. (2019) focus on understanding if, in restaurant sector, franchising as a firm characteristic induce significant differences in the behavior of earnings management. To precisely understand

earnings management behavior, it may be needed to consider the effect of franchising in the way that non-franchise restaurants largely diver from franchise in terms of information asymmetry and raising capital. According to the results of Gim et al. (2019) study, during growth stage, earnings management within restaurant sector is more actively performed in franchise firms than in non-franchise firms. Also, regarding earnings management, the effect of financial leverage is weaker for franchise restaurants than non-franchise restaurants (Gim et al., 2019). In the big picture, franchise restaurants are broadly more inclined towards earnings management (Gim et al., 2019).

The results presented by Gim et al. have contributed to the understanding of restaurant companies' behavior in use of franchising business model and without, as well as the knowledge on earnings management filled the research gap within this topic. Although, no assumptions were made regarding lodging sector. Indeed, this study focus on trying to understand not just the relation between franchised restaurant companies and earning management but also with the lodging sector as well as the impact in each one.

3. Methodology

3.1. Sample description

The sample used in this research was composed by lodging and restaurant firms, held publicly, and listed in NYSE (former AMEX) and NASDAQ. In order to guarantee the financial data needed to pursue this study, we identify and selected all companies listed in the markets referred above under the standard industry classification (SIC) code 5812 and 7011, and which financial data were available at Bloomberg database. Financial data were derived from each company's annual 10-K⁴ reports and from Bloomberg database. This study's sample was composed by dollar-based lodging and restaurant firms. The sample is composed by 15 lodging firms, of which 6 firms presented franchising properties and 9 did not. Regarding restaurant sector, the sample accounts with 45 restaurant firms, 30 under franchising agreements. From the original set of companies within NYSE and NASDAQ market companies, under the SIC codes already listed, should be noted that firms without the necessary financial data available publicly were excluded from the sample. Outliers were excluded based on earnings management dependent variable using *Tukey's* box plot weighted by 3.

3.2. Earnings Management as dependent variable

Accrual portion of accounting earnings was the main focus of anterior studies that were trying to capture the degree of earnings (Campa, 2015). Cash earnings are recognized by the actual money transfer, unlike them, accrual earnings reflect only judgments and estimations of income that wasn't received yet and expenses recognized but not paid (Lunghofer, 2010). This opens the opportunity to managers engage in manipulative options.

Discretionary accruals and non-discretionary accruals are a way to broke down accruals into two components (Hribar and Collins, 202). Improve profits due to manipulation is a concern to investors that know that estimations depend on managers judgement and they may or may not intentionally underestimate the loss value damage can make. This is

⁴ Annual 10-K is a comprehensive summary report of company's performance that must be submitted annually to the Securities and Exchange Commission.

an example of discretionary accruals. Contrarily, non-discretionary accruals reduce the room of error in the managers judgement because they are, generally, explicitly documented, such as catering bill.

We conclude that to measure earnings management in a reliably way, we must separate discretionary from non-discretionary accruals. Accruals are defined as part of income and expenses that are not implied in charges or payments (Callao et al., 2010) and can be calculated indirectly by the difference between operating income and cash flow (Larcker, Richardson, & Tuna, 2004). Accruals are one of the most widely used forms for empirical detection of earnings management.

Following the previous literature, the accruals were determined according to the following expression:

$$TA_{i,t} = \Delta Rec_{i,t} + \Delta Inv_{i,t} - \Delta Payables_{i,t} - DEP_{i,t} \quad (1)$$

Jones (1991) determined accruals as a function of company turnover variation and its' tangible asset. Dechow et al. (1995) adjusted the model removing the effect of credit sales growth and presented *Modified Jones*. *Modified Jones* were the model selected as the most appropriate one for dependent variable of this study considering the set of explicative variables under use, preventing multicollinearity issues within regression.

$$\frac{TA_{i,t}}{A_{i,t-1}} = \alpha_0 + \alpha_1 \frac{1}{A_{i,t-1}} + \alpha_2 \frac{(\Delta Sales_{i,t} - \Delta Rec_{i,t})}{A_{i,t-1}} + \alpha_3 \frac{PPE_{i,t}}{A_{i,t-1}} + \varepsilon_{i,t} \quad (2)$$

The coefficients were estimated from Equation 2 for each sample and then used for calculating the discretionary accruals, estimated through Modified Jones model, to capture earnings management behavior.

Table 1 – Determinants of earnings management dependent variable

Variables	Description
$A_{i,t-1}$	Total asset of each company i , for the period $t-1$
$DEP_{i,t}$	Total depreciation of each company i , for the period t
$\Delta Inv_{i,t}$	Variation of inventories of each company i , for the period t

Variables	Description
$\Delta Payables_{i,t}$	Variation of accounts payable of each company i , for the period t
$PPE_{i,t}$	Total property, plant and equipment (representing tangible assets) of each company i , for the period t
$\Delta Rec_{i,t}$	Variation of accounts receivables of each company i , for the period t
$\Delta Sales_{i,t}$	Variation of sales of each company i , for the period t
$TA_{i,t}$	Total Accruals of each company i , for the period t

3.3. Explanatory Variables

Franchising Variable: To conduct this research, a ratio scale variable was used to measure franchising degree ($DOF_{i,t}$). ($DOF_{i,t}$) represents total properties under franchising agreements divided by total properties owned by company i , in period t . If the firm is totally managed under franchising agreements, $DOF_{i,t} = 1$, in case firm don't have any franchised property or restaurant, ($DOF_{i,t}$) account for zero.

Control Variables: The choice of control variables was made based on data availability and in line with previous research. This study investigated franchising degree effect on earnings management and compare the effect of ($DOF_{i,t}$) in lodging and restaurant industries. The selected control variable was firm size ($SIZE_{i,t}$), profitability ($ROA_{i,t}$), employment ($Employ_{i,t}$), total stakeholders' equity ($Equity_{i,t}$) and *year dummies*.

Profitability ($ROA_{i,t}$) is one of the most important determinants of earnings management. Like Lee et al. have demonstrated in 2006, the relation between discretionary accruals and the firm's profitability shows us that higher profitability have larger discretionary accruals, so, it is more often to managers at highly profitable firms engage in earnings management.

Another control variable used was the firm size ($SIZE_{i,t}$). It has been shown in the past studies that firm's size and earnings managements when correlated reported mix results. Gu et al. (2005), defended that big companies have more external attention and control than small companies, so he concludes that is less likely to managers engage in earnings management. However, research conducted by Hochberg (2011) concludes that size firm

make it more or less complex, and he claim that bigger the company more complex it is to control it, which in the end facilitates managers to engage in earnings management.

Control variable regarding total stakeholders' equity and total number of employees was introduce, too. In this research, in order to prevent the effect of year specific events on the results, was included year dummies (*Year dummies*) to control de period from 2000 to 2017. It should be noted that after elimination of outliers, in final set, no observation regarding year 2000 were presented, so, year dummy was adjusted for the period of 2001 to 2017.

Additionally, was performed an initial assignment on the individual significance by running logistic regression for each independent variable, individually, supporting the choice of which one to include. The following table presents the variables included in this research.

Table 2 – Measurements of dependent and independent variables

Variables	Measurements
Degree of Franchising ($DOF_{i,t}$):	Ratio between total properties under franchising agreements and total properties
Discretionary accruals ($DACC_{i,t}$)	Modified Jones Model (1995)
Firm Size ($SIZE_{i,t}$)	Log of total assets
Profitability ($ROA_{i,t}$)	Net income scaled by total asset
Employment ($Employ_{i,t}$)	Total number of employees
Total stakeholders' equity ($Equity_{i,t}$)	Total stakeholders' equity
<i>Year dummy</i> (2000-2017)	Year dummy, accounting 1 if the observation corresponds to the year of dummy and 0 if not

3.4. Regression Model

$$DACC_{it} = \beta_0 + \beta_1 DOF_{it} + \beta_2 SIZE_{it} + \beta_3 ROA_{it} + \beta_4 Equity_{it} + \beta_5 Employ_{it} + Year\ dummies + \varepsilon_{it} \quad (3)$$

According to section 3.2, $DACC_{it}$ represents the effect of earnings management through accruals calculations. This model aims to relate degree of franchising (DOF_{it}) with earnings management dependent variable ($DACC_{it}$). In accordance with previous research, is expected that (DOF_{it}) has a positive impact on earnings management.

Additionally, is also intended to compare the results for lodging and restaurant industries, for which almost none literature exist regarding this specific topic.

Reflecting the structure of collected data, an ordinary least square model was performed. Model quality assurance was verified through robustness testing, as presented in appendix.

4. Results Analyses

4.1. Descriptive information

Firstly, prior to analyze the regression model, this thesis examined the descriptive information for the variables used in this study.

Table 3 – Descriptive statistics

Variables	Mean		Std. Deviation	
	Restaurant	Lodging	Restaurant	Lodging
$DOF_{i,t}$	42,9158%	24,2621%	37,2589%	34,3312%
$Employ_{i,t}$	38424,1342	5194,45427	98834,5295	55798,2465
$Equity_{i,t}$	776,7686	1146,7311	2097,7288	2001,3236
$ROA_{i,t}$	6,4176%	10,3540%	8,3874%	27,0196%
$SIZE_{i,t}$	2,7911	3,3889	0,7052	0,5765

As presented in Table 3 – Descriptive statistics, differences can be identified comparing both industries. Firstly, franchising degree is higher in restaurant sector, presenting a mean value of 42,92% comparing to lodging industry, that have accounted 24,26% for mean value. In accordance to lodging industry characteristics, such as higher levels of assets for instance of hospitality operation, lodging sector presents higher mean values of total equity ($Equity_{i,t}$), firm's size ($SIZE_{i,t}$) and return on asset ($ROA_{i,t}$). This indicates that, on average, lodging industry presents higher asset value, higher equity value and higher profitability when compare to restaurant sector. It should be noted that the mean value for ($ROA_{i,t}$), in restaurant industry, amount for 6,42%, and, in lodging sector, for 10,35%. Generally, in this sample, lodging companies have more employees than restaurant firms.

Concerning ($DOF_{i,t}$) standard deviation, we can conclude that the sample values for this variable within lodging sector are more concentrated around mean value, when compared to restaurant sector. This trend is observed in all control variables, excluding return on asset ($ROA_{i,t}$) that presents a standard deviation of 27,02%, for lodging sector, and 8,29%, for restaurant industry.

In higher picture, restaurant industry tends to present increased presence of franchise properties comparing to lodging sector. The impacts of $(DOF_{i,t})$ on earning management behavior is further analyzed in next topic.

4.2. Main analysis results

Table 4 – The effect of franchising on earnings managements – evidences from restaurant and lodging firms presents regression results from both lodging and restaurant industries, regarding the influence of degree of franchising $(DOF_{i,t})$ on earnings management, as well as the control variables.

Table 4 – The effect of franchising on earnings managements – evidences from restaurant and lodging firms

Dependent Variable: $DACC_{i,t}$	Ordinary least square model	
	Restaurant	Lodging
$DOF_{i,t}$	0,028*** (0,007)	11,225 *** (1,622)
$Employ_{i,t}$	1,376E-5*** (0,000)	-2,221E-5 ** (0,000)
$Equity_{i,t}$	0,001*** 0,000	-0,001*** (0,000)
$ROA_{i,t}$	0,045 0,032	0,141 *** (0,029)
$SIZE_{i,t}$	-8,834*** (0,489)	3,289 *** (1,186)
Constant	23,162*** 1,926	-13,315*** (4,847)
No. of Obs.	395	143
No. of Firms	45	15
Adjusted R ²	0,514	0,277
F-statistics	21,877***	3,716***

Note: $DACC_{i,t}$ = discretionary accruals, $DOF_{i,t}$ = degree of franchise; $Employ_{i,t}$ = total number of employees; $Equity_{i,t}$ = total stakeholders' equity; $ROA_{i,t}$ = return on asset, $SIZE_{i,t}$ = firm size (natural log of total assets).

* $p < 0,1$

** $p < 0,05$

*** $p < 0,01$

The main focus of this dissertation was to detect the effect of degree of franchising ($DOF_{i,t}$) on earnings management. As can be seen in the table presented above, ($DOF_{i,t}$) have a positive impact on earnings management (coefficient_{restaurant} = 0,028; coefficient_{lodging} = 11,225) and this variable is statically significant form both industries (p-value < 0,01). The results indicate that for higher values of degree of franchising, i.e. higher ratio of franchise properties divided by total properties, induce a positive effect on earnings management behavior. In other words, earnings management behavior and degree of franchising ($DOF_{i,t}$) vary in the same direction so, in general, increases in franchise properties, with everything else remaining constant, increase earnings management behavior. This results are in line with the Gim et al. paper, the first conducted in this field, relating earnings management with franchising.

Comparing the effect of franchising variable in both sectors, can be concluded that, in lodging sector, the effect of degree of franchising on discretionary accruals have higher impact (coefficient = 11,225) comparing to restaurant industry (coefficient = 0,028).

The coefficients of control variables are in line with the earlier literature presented in section 3.3.

5. Conclusion

This regression model date from 2000 on the influence of degree of franchising on earnings management behavior. The OLS model showed evidences of a positive relation between $DOF_{i,t}$ and $DACC_{i,t}$, meaning that, higher degree of franchising within a firm influence positively the behavior of earnings management. In industries comparison, lodging showed to have a higher impact on earnings management in presence of franchising agreements, when compared to restaurant firms.

This matter can be related to the fact that population, in general, have higher awareness of restaurant brands when in compare to lodging brands. In the 2019 rank for *The World's Most Valuable Brands*, published by Forbes, one of the 10 most powerful brand is a restaurant firm (MacDonald's) and including food & beverage segment, category directly related to restaurant, the top 50 accounts with 5 firms related to restaurants industry. Within top 50, no brands related to lodging were identified. Since lodging firms presents lower brand awareness, this sector needs to push further in other topics to attract investors to franchising agreements and this can be a reasonable justification for higher influence of degree of franchising on earnings management, on lodging sector, when compare to restaurant sector.

This study aimed, and showed, the positive relation between franchising and earnings management and the results were align with Gim et al. (2019) research. The presented dissertation is limited to a sample of American publicly held companies within lodging and restaurant field, from the period of 2000 to 2017 fiscal years.

Although the recent enforce to fill the gap in this specific matter, further research regarding the relationship between franchising and earnings management should be performed. It may also be desirable to explore other factors that are impacting earnings management when interacting with degree of franchising, such as industries specificities or firms' characteristics. On the other hand, managers are performing more actively real earnings management, that stands for real economic activities (e.g. spending on research and development, maintenance, advertising). In that matter, it may also be advisable to further investigate this hot topic under the franchising matter.

This result may have relevant implications in order to better understand which characteristics potentiate the behavior of earnings management, allowing regulatory forces to act in advantage and to better trigger inspections and audits. Academic

community, in other hand, shall use the result presented to leverage the knowledge regarding this subject and allow for further developments.

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7. Appendix

7.1. Appendix A - Robustness tests for lodging industry

Collinearity Diagnostics^a

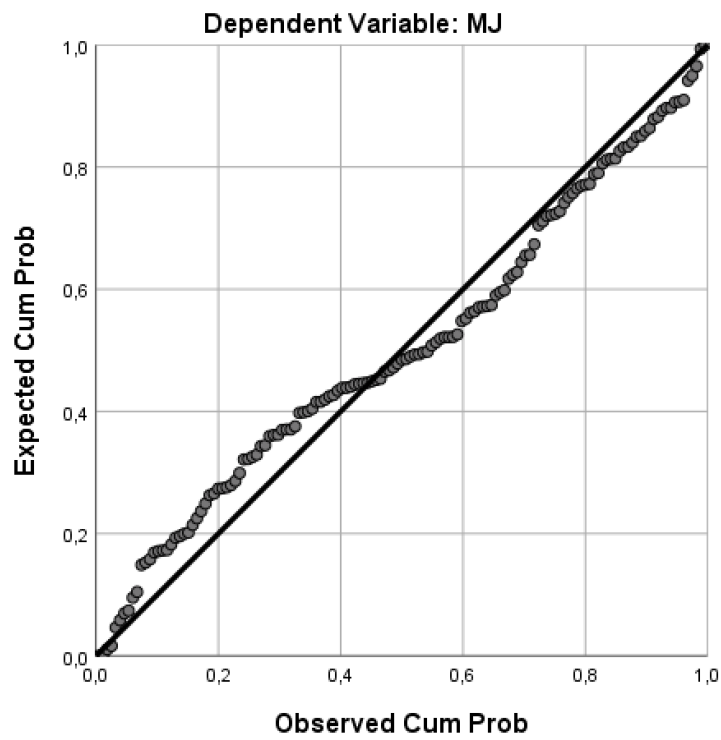
Model	Dimension	Eigenvalue	Condition Index	(Constant)	DOF	Size	ROA	Variance Proportions				
								Total Equity	Number of Employees - CSR	@2017	@2016	@2015
1	1	3,927	1,000	,00	,02	,00	,01	,01	,00	,00	,00	,00
	2	1,238	1,781	,00	,00	,00	,00	,00	,36	,07	,00	,00
	3	1,208	1,803	,00	,02	,00	,11	,07	,01	,00	,00	,00
	4	1,038	1,945	,00	,03	,00	,01	,00	,00	,00	,00	,02
	5	1,019	1,963	,00	,00	,00	,00	,00	,00	,00	,05	,00
	6	1,000	1,981	,00	,00	,00	,00	,00	,00	,00	,03	,02
	7	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,00	,01
	8	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,00	,00
	9	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,02	,01
	10	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,00	,00
	11	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,06	,02
	12	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,00	,02
	13	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,00	,00
	14	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,00	,07
	15	1,000	1,982	,00	,00	,00	,00	,00	,00	,00	,00	,01
	16	,909	2,079	,00	,01	,00	,07	,04	,02	,00	,02	,01
	17	,763	2,268	,00	,05	,00	,00	,01	,52	,10	,00	,00
	18	,564	2,640	,00	,73	,00	,04	,01	,08	,02	,00	,01
	19	,306	3,583	,00	,09	,00	,48	,63	,00	,00	,01	,00
	20	,020	13,906	,03	,00	,28	,08	,05	,01	,74	,67	,68
	21	,008	22,409	,97	,04	,71	,19	,17	,01	,07	,11	,11

Collinearity Diagnostics^a

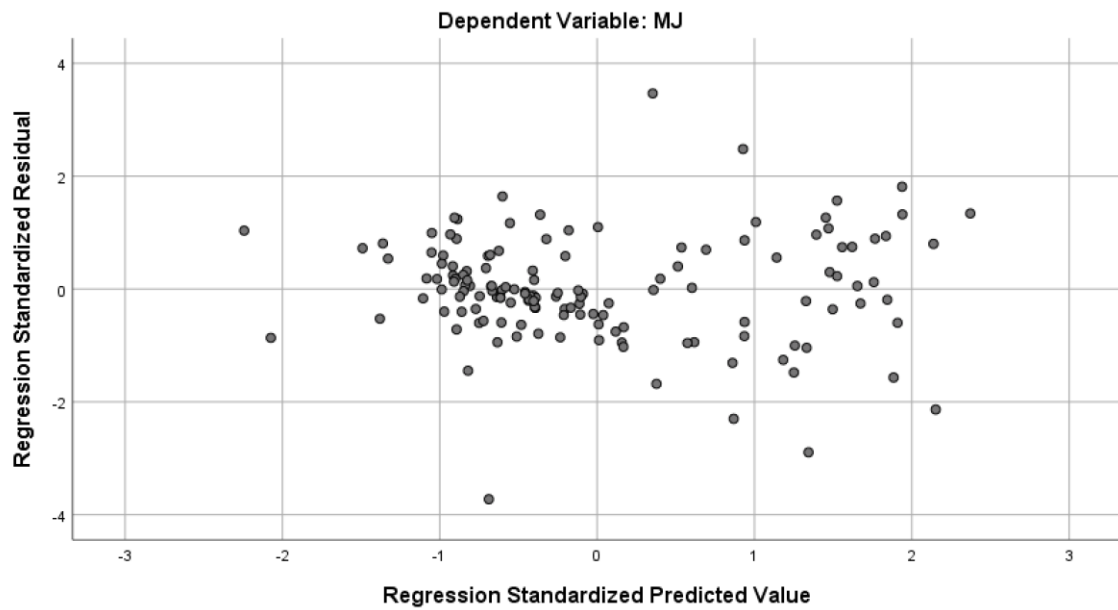
Model	Dimension	Variance Proportions											
		@2014	@2013	@2012	@2011	@2010	@2009	@2008	@2007	@2006	@2004	@2003	@2002
1	1	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00
	2	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00
	3	,00	,00	,00	,01	,00	,01	,02	,01	,00	,01	,01	,02
	4	,00	,00	,00	,01	,04	,07	,03	,00	,00	,00	,08	,05
	5	,01	,00	,02	,00	,02	,02	,00	,05	,07	,00	,01	,02
	6	,02	,01	,03	,08	,02	,00	,01	,01	,00	,00	,07	,02
	7	,00	,05	,13	,03	,00	,00	,02	,00	,06	,00	,00	,00
	8	,00	,00	,00	,08	,11	,02	,00	,00	,06	,02	,01	,00
	9	,05	,10	,00	,00	,03	,02	,01	,00	,01	,00	,03	,00
	10	,00	,02	,00	,00	,00	,00	,01	,00	,01	,02	,17	,16
	11	,06	,00	,02	,00	,03	,02	,01	,01	,02	,01	,00	,00
	12	,00	,04	,05	,03	,01	,04	,01	,08	,01	,01	,00	,00
	13	,01	,01	,00	,00	,01	,01	,00	,02	,00	,21	,00	,09
	14	,03	,01	,00	,00	,01	,02	,01	,05	,05	,03	,00	,00
	15	,02	,00	,00	,01	,00	,04	,16	,06	,00	,00	,00	,01
	16	,01	,01	,02	,04	,00	,03	,03	,01	,00	,02	,02	,02
	17	,00	,00	,00	,00	,00	,00	,00	,00	,00	,01	,01	,01
	18	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,02	,02
	19	,00	,00	,00	,00	,01	,01	,00	,00	,00	,00	,00	,00
	20	,68	,62	,59	,57	,55	,51	,53	,55	,56	,52	,43	,43
	21	,10	,12	,13	,14	,16	,17	,15	,13	,13	,13	,14	,14

a. Dependent Variable: MJ

Normal P-P Plot of Regression Standardized Residual



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7.2. Appendix A - Robustness tests for restaurant industry

Collinearity Diagnostics^a

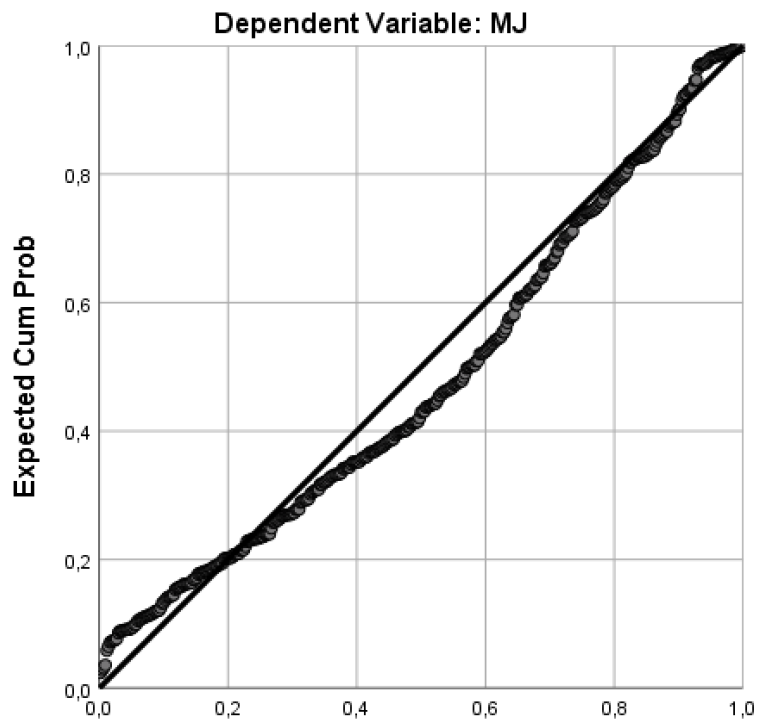
Model	Dimension	Eigenvalue	Condition Index	(Constant)	DOF	Size	ROA	Variance Proportions					
								Total Equity	Number of Employees - CSR	@2017	@2016	@2015	
1	1	4,554	1,000	,00	,01	,00	,01	,01	,01	,01	,00	,00	,00
	2	1,220	1,932	,00	,01	,00	,00	,12	,12	,12	,01	,01	,00
	3	1,043	2,090	,00	,00	,00	,02	,00	,01	,01	,02	,02	,00
	4	1,025	2,108	,00	,00	,00	,01	,02	,02	,00	,03	,00	,00
	5	1,002	2,132	,00	,00	,00	,00	,00	,00	,00	,01	,00	,02
	6	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,00	,00	,06
	7	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,00	,01	,04
	8	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,00	,00	,02
	9	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,01	,01	,01
	10	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,01	,03	,02
	11	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,03	,01	,00
	12	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,02	,02	,01
	13	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,01	,02	,00
	14	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00
	15	1,000	2,134	,00	,00	,00	,00	,00	,00	,00	,01	,02	,00
	16	,941	2,200	,00	,00	,00	,00	,07	,03	,03	,04	,02	,01
	17	,509	2,991	,00	,02	,00	,75	,10	,03	,03	,00	,00	,00
	18	,346	3,630	,00	,73	,00	,03	,13	,15	,01	,01	,01	,00
	19	,319	3,778	,00	,20	,00	,15	,41	,51	,00	,00	,00	,00
	20	,031	12,041	,00	,03	,56	,02	,11	,04	,34	,35	,35	,32
	21	,011	20,733	,99	,00	,43	,01	,03	,10	,46	,46	,46	,46

Collinearity Diagnostics^a

Model	Dimension	Variance Proportions												
		@2014	@2012	@2011	@2010	@2009	@2008	@2007	@2006	@2005	@2004	@2003	@2002	
1	1	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00
	2	,00	,00	,00	,00	,00	,00	,00	,00	,00	,00	,01	,02	,01
	3	,00	,00	,00	,00	,01	,05	,02	,04	,02	,05	,00	,07	,00
	4	,00	,00	,01	,00	,01	,02	,03	,00	,01	,03	,19	,01	,00
	5	,00	,10	,00	,03	,01	,07	,05	,00	,01	,00	,00	,00	,00
	6	,04	,01	,00	,02	,00	,00	,05	,05	,01	,02	,02	,03	,00
	7	,01	,00	,11	,04	,03	,00	,00	,06	,01	,00	,00	,00	,00
	8	,01	,05	,00	,07	,05	,00	,00	,03	,04	,01	,05	,00	,00
	9	,01	,04	,04	,03	,06	,05	,03	,01	,00	,01	,00	,03	,00
	10	,02	,01	,00	,03	,08	,01	,00	,04	,03	,01	,01	,00	,00
	11	,06	,02	,00	,02	,00	,01	,01	,01	,10	,01	,01	,06	,00
	12	,01	,00	,00	,00	,01	,07	,06	,03	,00	,01	,03	,07	,00
	13	,02	,01	,04	,02	,02	,01	,03	,06	,01	,07	,01	,00	,00
	14	,00	,00	,00	,02	,04	,00	,02	,01	,01	,19	,01	,11	,00
	15	,05	,00	,07	,01	,00	,00	,01	,01	,13	,00	,03	,01	,00
	16	,00	,03	,03	,02	,02	,02	,00	,00	,01	,01	,01	,02	,00
	17	,00	,01	,01	,00	,00	,00	,01	,01	,00	,00	,01	,00	,00
	18	,00	,01	,00	,01	,01	,01	,00	,00	,00	,00	,00	,00	,00
	19	,00	,00	,00	,00	,00	,00	,01	,01	,01	,03	,01	,03	,00
	20	,28	,25	,25	,24	,25	,27	,25	,24	,24	,24	,24	,24	,24
	21	,47	,44	,42	,44	,41	,40	,41	,40	,37	,32	,33	,31	,31

a. Dependent Variable: MU

Normal P-P Plot of Regression Standardized Residual



Scatterplot

