The Hospitality Industry – Where Do We Go From Here?

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Owners and/or operators of hotels and restaurants are facing unprecedented times. With the current state of the COVID-19 pandemic, it is not difficult to imagine that the economic impact could linger on for several more months and potentially years to come. Although hotel and restaurant sectors are hoping for a vaccine to cure economic ills, a recent Gallup poll showed that 35% of the U.S. population would opt not to take it, which would further delay the recovery.

Backdrop

Mandatory hotel closures dictated by state and local governments, a steep decline in discretionary income and an overall reduction of economic activity have contributed to a forecasted decline of Q4 2020 REVPAR (Revenue Per Available Room) of between 50-70% year-over-year for full service hotels. For the months of July and August 2020, gross operating profit (GOP) as a percentage of total revenues for full service hotels was negative 13%. The obvious reason for the decrease in occupancy rates (and negative GOP) was primarily due to fewer corporate conferences and meetings and postponed or cancelled vacations. While there is some uptick in the leisure market, the increase in activity in the leisure market cannot replace most of the lost corporate demand.

As a result, a high percentage of hotels and restaurants either are in default, or are in serious delinquency, of their mortgages. Many hotels and restaurants are tapping into their capital reserves to cover interest payments. Due to limited or significant decrease in business, many hotels and restaurants failed debt service coverage ratios which will trigger cash flow sweeps (lockbox).

Given the projection of volatility for the foreseeable future, it is important for hotel and restaurant owners and/or operators and investors to engage outside advisors that not only understand the current accounting and tax landscape but can also provide tactical and commercial solutions to address the risks related to the pandemic.

With many lenders and investors now facing the end of forbearance on debt service payments and mounting pressures from shareholders for performance and recovery initiatives, hotel and restaurant owners and/or operators should consider retaining third party advisors to optimize their financial position to prepare for an extended recessionary period.

Below are several accounting areas of focus that hotel and restaurant operators and/or owners should review during this pandemic.

Leases

The pandemic has created significant strain on many lessees. Concessions like free rent, deferral of rent payments, extension of the lease term or, in some cases, cash payments being offered by many landlords to retain their tenants, etc. Concessions that are considered modifications under generally accepted accounting principles in the United States of America (US GAAP) may result in complex accounting requirements.

- For lessees who have implemented Accounting Standards Codification Topic 842, the modification of the lease could require a re-measurement of lease liability and the carrying amount of the right-of-use assets, update of the discount rate, and evaluation of impairment of the right-of-use assets. The lessor will have to perform similar evaluations and will have to focus on the lessee's credit risk to determine any possible impairment.
- For lessors (landlords) that are still recognizing rental income on a straight-line basis, a modification of the lease could require a recalculation of the rental income to be recognized over the remaining term of the lease.

If there were no modifications to the lease agreement, lessors still need to evaluate the probability of collection of lease payments from the lessee based on the financial health of the lessee. If the lessor determines that collectability of lease income is no longer probable, the lessor should recognize lease income only when the lessee makes the lease payments. Lessors should also evaluate the probability of collection of lease income in arrears and, if needed, record an allowance for doubtful accounts.

Fair Value Measurements

US GAAP and International Financial Reporting Standards (IFRS) both define fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The orderly transaction concept is designed to differentiate between what is considered a fair value measurement versus a distressed sale or a forced transaction. The pandemic has caused significant to extreme stress in market conditions. In assessing fair value of assets, careful analysis should be made to conclude if market observable inputs should be disregarded if they were based on transactions that were not orderly transactions.

Goodwill and Other Intangible Assets

US GAAP and IFRS generally require an entity to test its goodwill and other intangible assets for impairment annually, or when events and circumstances indicate that such assets may be impaired. The pandemic has caused temporary or permanent closure of hotels and restaurants, and either a decrease in or loss of business. These are all triggering events that should be considered in impairment evaluations since such events create a negative effect on earnings and cash flows.

Property, Plant, and Equipment (PP&E)

US GAAP and IFRS require an entity to test its PP&E at the asset level group for recoverability whenever events or circumstances indicate that the carrying amount of such PP&E may no longer be recoverable. The pandemic is an event or circumstance that may lead an entity to question whether its PP&E is fully recoverable given the significant decline in business and the future outlook. Careful and thorough analysis should be performed in the determination of recoverability. If an entity determines that certain asset classes within PP&E are no longer recoverable, an impairment charge should be recorded.

Debt

The decrease in business brought by the pandemic caused many hotel and restaurant operators and/or owners to be unable to make required debt service payments. Many lenders are working with hotel and restaurant operators and/or owners to address payment terms, covenant violations and, in some cases, reduce the carrying amount of the debt.

Entities that have received concessions from their lenders need to assess the required accounting for any deferred payments, amortization of deferred financing costs and, if applicable, the reduction of the carrying amount of the debt. If there are covenant violations, the classification and presentation of the debt should also be carefully evaluated depending on arrangements with lenders. Entities should also consider whether any modifications meet the troubled debt restructuring accounting guidance. If they do not meet the troubled debt restructuring accounting guidance, an entity should analyze whether the changes in the terms should be accounted for as a modification or as an extinguishment.

Loss Contingencies

Transactions and actions made by hotel and restaurant owners and/or operators in response to the pandemic may raise certain legal matters and contingencies. If such contingent losses are probable and can be reasonably estimated, the amount of losses should be recorded as a charge to income.

Paycheck Protection Program Loan (PPP Loans)

Many hotel and restaurant owners/operators obtained PPP Loans as part of the CARES Act. The calculations for the forgiveness of PPP Loans are based on, among other things, allowed payroll expenses incurred and full-time employee equivalent counts. While many hotels and restaurants are slowly reopening as allowed by local authorities, employee count is still not at pre-pandemic levels.

Although the Small Business Administration (SBA) has released guidance during the past few months, there are still many unanswered questions on the application of rules and guidance. Much care and analysis is required for the accounting and the tax implications of forgiveness of PPP Loans. We invite you to visit our COVID-19 Resource Center for information on various business matters related to the pandemic.

Taxes

Federal, state and local tax authorities have provided some reprieve to entities, such as the following:

- Net operating losses (NOLs) originating in tax years beginning after December 31, 2017 – and before January 1, 2021 (2018, 2019 and 2020 for calendar year taxpayers) – can be carried back 5 years from the year the NOL originated. For tax years ending before January 1, 2021, the CARES Act eliminated the 80% taxable income limitation for NOL carryforwards.
- Employee retention credit equal to 50% of each employee's qualified wages, up to a maximum of $10,000 of wages, capped at $5,000 per employee, for those entities that did not obtain a PPP Loan, subject to certain limitations. [Please refer to our newsletter on employee tax credits for further details.]
- Delayed the timing of required federal tax deposits for certain employer payroll taxes and self-employment taxes incurred between March 27, 2020 and December 31, 2020.

As discussed above, an entity may be required to recognize impairment adjustments, and record reserves and certain accruals on its financial statements due to the pandemic. These adjustments may create timing differences that may have to be accounted for as either a deferred tax liability or asset. For entities that have NOL carryforwards, and have recorded a deferred tax asset, careful consideration should be made whether such asset is realizable or not. Similar evaluation of realizability should also be made for other deferred tax assets. Entities should also consider the accounting implications if they elect to amend their tax returns to take advantage of the NOL carryback reprieve discussed above.

Contact Us

PKF O’Connor Davies, in conjunction with PKF hotelexperts, the oldest hospitality consulting firm in the world, offers an array of services including comprehensive operational and financial audit services that provides a holistic view of hotel and restaurant investments.

If you have any questions on the topics discussed in this hospitality industry bulletin, please do not hesitate to reach out to either of the below. We are here to help.

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About PKF O'Connor Davies

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