# I Purchased a Hotel … Is it an Asset or a Business?

*Accounting for Acquisitions in the Hospitality Industry*

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The tourism and hospitality industry is beginning to regain its footing and bounce back from the pandemic. Travelers are eager to return to their favorite vacation destinations and business hubs. The positive hospitality forecast has stimulated the real estate market for hotels, with transaction volumes in the sector increasing daily. The sales of these hotels pose new accounting challenges to purchasers as they are faced with the issue of "Am I buying an asset or a business?" Both outcomes of this decision have very different requirements for the accounting of the acquisition and have significant reporting impacts.

## Fundamental Guidance

When buying a hotel there are many intricacies to the transaction that dictate what the underlying purchase is and whether it is an asset acquisition or a business combination. A careful analysis of the acquisition allows the purchaser to properly account for the transaction, while following the guidance in FASB ASC topic 805, *Business Combinations,* and ensures Generally Accepted Accounting Principles (GAAP) are properly applied. The topic is complex and open to interpretation with every transaction. Investors who are new to the sector may not be familiar with the acquisition nuances of a hotel and implementing the guidance will be new, unexplored territory.

To determine whether a business or an asset was acquired, the buyer should use the authoritative guidance in ASC 805-10-55 as a starting point. This subtopic of the guidance will provide the definition of a business and the criteria necessary to determine if a business was, in fact, acquired or if an asset, such as real estate, was purchased.

## Business or Asset

According to ASC 805-10-55-3A, the definition of a business is: "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants."

To operate a business, there are three necessary components:

1. **Inputs** – franchise/management agreement or an organized and skilled workforce, etc.
2. **Processes** – operational and resource management processes associated with operating the hotel, etc.
3. **Outputs** – revenues from operating the hotel, etc.

A business will have been acquired if both inputs and processes are present and included in the assets acquired; outputs, however, need not be present at the time of acquisition.

Understanding what components are included in the purchase begins with identifying what assets were acquired and their relationship to one another. If the acquisition is concentrated in a single identifiable asset or similar group of assets, an asset is being acquired and not a business. If the acquisition consists of various components that do not constitute a single identifiable or similar group of assets, then the purchaser must evaluate if the assets acquired comprise the necessary components to form a business.

## Accounting for a Business Acquisition

If it is determined that a business was acquired, ASC 805-10-05-4 provides the authoritative guidance for the “acquisition method of accounting,” which is the required methodology for business combinations under GAAP.

The acquisition method of accounting can be broken down into four steps:

1. Identify the acquirer
2. Determine the acquisition date
3. Recognize and measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree
4. Recognize and measure goodwill or a gain from a bargain purchase

## Accounting for the Acquisition of an Asset

If it is determined that the transaction is an acquisition of an asset, then the “cost accumulation method” of accounting should be used as described by the guidance in ASC 805-50-55.

The first step of recognizing the acquisition of an asset under the cost accumulation method is determining the consideration and direct and incremental costs associated with the acquisition. These amounts constitute the costs of the acquisition which are then allocated to the asset components acquired using the relative fair value method. The value of the asset components utilized in the calculation of the relative fair value of the assets must be based on reliable and accurate data to ensure proper reporting within the balance sheet.

## Further Considerations

These accounting treatments greatly impact the financial statements and, as such, the facts need to be carefully considered to ensure that the income statement and balance sheet accurately reflect the transactions. Although in some situations it may seem that only assets were acquired, the income statement may still be affected due to the accounting for the transaction or acquisition costs incurred or the possible recognition of a gain from a bargain purchase.

Whether an asset or a business is acquired, there are transaction costs incurred such as legal, accounting, valuation, and other professional fees. The conclusion of whether an asset or a business was acquired determines how these costs are accounted for. If an asset is acquired, the direct and incremental costs associated with the acquisition are allocated to the relative fair value of the assets acquired and are capitalized. If a business was acquired, these acquisition costs are expensed during the period incurred.

Additionally, if a business is purchased and there is an excess fair value of assets acquired over the purchase price, a gain on the bargain purchase will be recognized in the income statement. This gain should be carefully calculated based on the best information available to the acquirer at the time of acquisition. As such, it is important to account properly for the identifiable assets purchased using accurate fair values. For many, this may be difficult to determine on their own and a Purchase Price Allocation (PPA) will need to be performed by an experienced third party.

The accuracy of reporting and the validity of information is paramount to owners and shareholders of a company. When investors are involved in a significant transaction, the proper accounting treatment is of great importance to ensure parties are protected and aware of all facts surrounding the transaction. Whether it is the buyer's first time purchasing a hotel or the 20th hotel in their portfolio, the proper accounting treatment should be carefully considered each and every time. With the help of accountants and accredited real estate appraisers, an investor can be assured that the reporting is accurate and can be relied on by the users.

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PKF O'Connor Davies offers an array of services and expertise to the hospitality industry. If you have any questions on these or other topics relating to the hospitality industry, we invite you to contact our hospitality industry specialists.

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