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CURRENT ACCOUNTING PRACTICES OF PREOPENING COSTS BY LODGING FIRMS —DO THEY VIOLATE U.S. GENERALLY ACCEPTED ACCOUNTING PRINCIPLES?

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ABSTRACT. This study examines the practice of accounting for preopening costs in U.S.-based hotels. The study surveyed 225 CFOs, controllers, and senior-level executives of lodging companies during the 2012–2013 period to examine current accounting practices for preopening costs in their firms. The research questions measured the amounts spent on preopening costs, key expenditures included as preopening costs; when/where these preopening costs were expensed, and the incentive operating fee arrangement. Results revealed that many lodging firms did not account properly for their preopening costs in accordance with U.S. Generally Accepted Accounting Principles (GAAPs). As such, the current practice of accounting of preopening costs in lodging firms is better understood and the need for further guidance on treatment of preopening expenses in the next (11th) edition of Uniform System of Accounts for the Lodging Industry (USALI) is explored.

INTRODUCTION

The complexity of owning and managing hotels has changed drastically in the past 50 years. For the most part, the owners of hotels have managed their hotels throughout the history of inn keeping. However, in the 1970s, many hotel owners were forced to engage operating companies to manage their hotels. Then, starting in the 1990s, major firms opted to separate management from ownership. For example, Marriott Corporation, in the early 1990s, split into a management/franchise company (Marriott International) and an ownership company (Host Marriott, subsequently renamed Host Hotels).

Marriott International (MI) manages many hotels owned by Host Hotels today. MI is generally paid for managing hotels based on sales (a base operating fee) and often gross operating profit (GOP; incentive operating fees). The percentage of sales portion is relatively easy to calculate; however, the calculation of GOP can be more difficult. What expenses are subtracted to determine GOP? More specifically, should the preopening expenses be subtracted before or after GOP? More fees will be earned by the management company if the preopening expenses are written off as amortization expense after GOP rather than if the preopening costs are expensed in the operated departments and as marketing expense. However, if preopening costs are expensed prior to the hotel opening, then management fees are not impacted.

When companies open a new property, questions are raised concerning how to account for preopening costs and even what constitutes the preopening costs. Although the *Uniform System of Accounts for the Lodging Industry* (USALI) has been a very useful guide in many accounting situations for the industry, little guidance in recent editions has been provided for accounting for preopening costs. The accounting for preopening costs is important because, depending on how they are accounted for, management fees and other related fees could be impacted. To clarify the ambiguity and to provide guidance, a study of how lodging industry firms account for their preopening costs has been conducted.

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LITERATURE REVIEW

Preopening costs include the soft costs incurred prior to the opening of a lodging property. Common expenditures shown as preopening costs are the costs for hiring and training staff and the early marketing costs, including the grand-opening party. These costs are incurred prior to the formal opening of a lodging property; thus, they are commonly referred to as preopening costs.

Prior to the release of the 9th edition of the USALI in 1996, preopening costs were capitalized and reported on the balance sheet as other assets (Damitio & Schmidgall, 1998). These costs were then amortized over a relatively short period of time, for example, 3 to 5 years, and shown as amortization expense on the income statement. The 8th edition, published in 1988, suggested preopening expenses be reported as other assets on the balance sheet and amortized as amortization expense over a short period of time (Hotel Association of New York City & American Hotel & Motel Association,1986).

The 9th edition of the USALI signaled a change in accounting for preopening costs, reflecting the practice (U.S. GAAP) of writing off preopening expenses immediately or expensing them over a period of no more than one year (Damitio & Schmidgall, 1998). In the section titled "Changes from the Prior Editions," the following is stated:

> Of particular note, this edition has deleted all references to preopening expenses (although properties that currently have recorded preopening expenses as an asset would continue that amortization until the asset is fully amortized). This action was taken because it has become common practice to write off preopening expenses as incurred or to amortize them over a period of no more than one year. (Hotel Association of New York City & American Hotel & Motel Association, 1996)

There was no further mention of preopening costs in the 9th edition, including the expense dictionary. The current 10th edition of the USALI does not include any guidance for accounting for preopening expenses, either (Hotel Association of New York City & American Hotel & Motel Association, 2006). Therefore, little guidance has been provided in the hospitality literature for accounting for preopening expenses other than that they be written off. As a result, a person might question whether lodging companies follow this practice appropriately. In fact, based on this research, it is revealed that the majority of respondents of this research study are following the rules stated in the outdated 8th edition of USALI rather than those outlined in the 9th edition and now the 10th edition.

The Financial Accounting Standards Board (FASB) specified the types of preopening costs as part of a larger category titled start-up costs (Financial Accounting Standards Board, 2011c). Examples of start-up costs include recruiting and training employees, whereas advertising costs are specified by FASB as non-start-up costs, as shown in Table 1 (Financial Accounting Standards Board, 2011a). Start-up costs per the FASB should be expensed rather than capitalized and amortized (Financial Accounting Standards Board, 2011b). This guideline is consistent with the 9th edition of USALI and reconciles conflicts with regard to how to account for preopening expenses.

Are preopening costs significant in amount? This question can be answered by looking at the annual publication by Hospitality Valuation Systems (HVS), *HVS Hotel Development Cost Survey 2010* (Sahlins, 2011). The combination of preopening and working capital as a percentage of the total lodging development costs averages 4%. Thus, a lodging development costing $50 million would include approximately $2 million for preopening costs and working capital.

The impact on management fees could be significant, depending on the accounting for preopening costs. Assume an incentive operating fee (IOF) of 10% of GOP. If $2 million of preopening costs are written off as a fixed charge in the first year, the IOF will be $200,000 greater than if they had been expensed to operations and marketing. Of course, these preopening costs should have

TABLE 1. Examples of Start-up Costs and Non-Start-up Costs FASB Section 720-15-55

Examples of Start-up Costs	Example of NON-Start-up Costs
• Travel costs, employee salary-related costs and consulting costs related to feasibility studies, accounting, legal, tax, and governmental affairs • Salary-related expenses for the management of the opening team • Travel costs including hotel charges, meals, and transportation for the opening team • Recruiting and training costs and meals for newly hired employees • Salary-related expenses for new employees • Security, property taxes, insurance, and utilities costs incurred after construction is completed but prior to opening	• Advertising costs • Costs of long-lived asset additions • Costs that can be capitalized as inventory • Deferred financing costs • Costs of furniture and cash registers • Costs to obtain licenses, if any • Security, property taxes, insurance, and utilities costs related to construction activities • Costs of leasehold improvements and furniture • Architect fees for the leasehold improvements

been expensed prior to the opening of the hotel. Thus, accounting for preopening costs today as has been done in the past would incur more cost for the hotel owners.

RESEARCH QUESTIONS

Because there has been little research published regarding preopening costs, several areas will be investigated. Though HVS has published some results, more research is warranted in order to determine the amounts spent on preopening costs. Further, preopening costs may vary from hiring and training of personnel prior to the lodging property opening to the costs of the grand-opening party. Just what expenditures constitute preopening costs is worth investigating. The accounting rules have changed regarding the expensing of preopening costs, so this research project investigates the extent to which the current methods of accounting for preopening costs reflect the current accounting rules. Finally, many hotels are managed, and the accounting for the incentive portion of operating fees could be impacted accordingly. Therefore, research regarding incentive operating fees also appears warranted.

The four research questions are as follows:

1. What amounts are spent by lodging operators on preopening costs?
2. What expenditures are included as preopening costs?
3. When and where are preopening costs expensed?
4. What is the IOF arrangement?

RESEARCH METHODOLOGY

A survey questionnaire was developed to address the major questions. Only financial executives can most likely answer questions regarding the desired detailed accounting information; for this reason, CFOs, controllers, and higher senior-level executives, such as CEOs, of lodging companies were contacted. The Hotel Management Survey (2011 and 2012) conducted by *Hotel Management* was used to construct the initial company list. The lodging companies in this research are categorized into three groups: Owners and Developers, Third-party Management Companies, and Hotel Brands. In addition to the companies from The Hotel Management Survey (2011 and 2012), selected financial management committee members of the American Hotel & Lodging Association (AH&LA) were included in this study. In total, 225 companies were included in this study. Some companies belong to multiple categories. The number of companies by company types is shown in Table 2.

The initial draft of the preopening survey questionnaire was sent to executives of 36 companies, and they were asked to critique the questionnaire. Twenty-five respondents shared their opinions on the draft of the questionnaire and the questionnaire was revised, reflecting their input.

The revised questionnaire was then mailed to executives including CFOs and controllers of the 225 companies. Forty-one responded by September 2012. To increase the response rate, a second survey was mailed in October, and 18 additional responses were returned by January

TABLE 2. Sample Company Type

Company Type	Number	Percentage
Brand Company	32	14%
Third-Party Management Company	72	32%
Hotel Owner	71	32%
Hotel Owner and Brand Company	2	1%
Third-Party Management Company and Hotel Owner	46	20%
Third-Party Management Company, Hotel Owner, Brand Company	2	1%
Total	**225**	**100%**

2013. In total, 59 financial executives responded, yielding a 26.2% response rate. Even though 59 is not a huge number, the 26.2% return rate is relatively high. Descriptive analysis was conducted for each question using the Statistical Package for the Social Sciences (SPSS; Version 17.0).

THE RESPONDENTS

Fifty-six respondents identified their company types (Table 3). Twenty-five (44%) respondents said they were with a company that was a management company that also owned hotels, and twenty (36%) said they were with third-party management companies. Exactly half (28, or 50%) of the respondents were CFOs, and one-quarter of the respondents were controllers (see Table 4). Sixteen (28%) companies identified their lodging properties as upper-midscale, and fourteen (25%) as midscale (see Table 5). Respondents were requested to reveal the size (number of rooms) and year of the most recently opened lodging facility. Forty (71%) indicated that their lodging facility had fewer than 200 guest rooms, and ten (18%) said they had between 200 and 500 guest rooms (see Table 6). The majority (39, or 71%) of the responding executives indicated that their most recent hotel opening had been within the most recent 3 years (see Table 7).

TABLE 3. Types of Companies Responding

Your Company Is a	Number	Percentage
Management Company, Hotel Owner	25	44%
Third-Party Management Company	20	36%
Hotel Owner	6	11%
Management Company, Hotel Owner, Brand Company	3	5%
Brand Company, Hotel Owner	2	4%
Total	**56**	**100%**

TABLE 4. Position Titles of Respondents

Your Position Title Is	Number	Percentage
CFO	28	50%
Controller	14	25%
CEO	4	7%
Accounting Supervisor	2	4%
Other	8	14
Total	**56**	**100%**

TABLE 5. Types of Hotels

The Majority of Your Lodging Properties Are	Number	Percentage
Luxury	2	4%
Upper-upscale	9	16%
Upscale	5	9%
Upper-midscale	16	28%
Midscale	14	25%
Economy	3	5%
Multiple Answers	8	14%
Total	**57**	**100%**

RESEARCH FINDINGS

The total preopening costs of the most recently opened hotel by each respondent's company ranged from $8,500 to $17 million, with the median of $336,868. As a percentage of the total development costs, the preopening costs ranged from 0.02% to 11%. The preopening costs' percentage for the first quartile was 1.5%, the median was 2.5%, and the third quartile was 5.0%. Fifty percent of responding financial executives revealed that the preopening costs of their most recently developed lodging facility

TABLE 6. Number of Rooms

Number of Rooms	Number	Percentage
Fewer than 200 rooms	40	71%
200–500	10	18%
501–1000	5	9%
>1000	1	2%
Total	**56**	**100%**

TABLE 7. Most Recent Year of Hotel Opening

The Year of Your Most Recent Hotel Opening	Number	Percentage
2008	6	11%
2009	10	18%
2010	10	18%
2011	11	20%
2012	18	33%
Total	**55**	**100%**

comprised between 1.5% and 5% of the total development costs (see Table 8).

Financial executives were requested to reveal the post-opening management fee structure for the most recently opened hotel that is managed. In particular, they were asked to indicate a base operating fee (BOF) percentage and the incentive opening fee (IOF) arrangement. The BOF as a percentage of total sales generally ranged from 2.5% to 5%. Only one respondent indicated that the BOF was based only on room sales. Twenty-three (41%) respondents identified their BOF as 3% of total sales, and 18 (33%) respondents indicated 4% of total sales (see Table 9). Only 21 executives provided their IOF arrangement, and the details are provided in Table 10. Virtually every IOF is different! However, most are based on an income figure after operating expenses are subtracted.

Regarding the question of what costs were included as preopening expenses, this study revealed that the majority of lodging firms included hiring and training costs (98%), and sales and marketing (96%) as preopening costs. Just over 70% indicated professional costs as part of preopening costs, and another 68% indicated that their firms included initial costs

TABLE 8. Preopening Costs

	Amounts	Percentage of Respondents
Part A		
	$ 8,500–$125,000	25%
	$140,000–$336,868	25%
	$350,000–$2,000,000	25%
	$2,685,000–$17,000,000	25%
	Total	**100%**
	Percentage of Total Development Costs	Percentage of Respondents
Part B		
	0.02%–1.5%	25%
	1.6%–2.5%	25%
	3.0%–5.0%	25%
	>5.0%	25%
	Total	**100%**

TABLE 9. Base Operating Fees

The Base Operating Fee Is _% of Sales	Number	Percentage
2.5% of total sales	3	5%
2% of total sales	2	4%
3% of net room sales	1	2%
3% of total sales	23	41%
4% of total sales	18	33%
5% of total sales	8	15%
Total	**55**	**100%**

TABLE 10. The Incentive Operating Fee (IOF) Arrangement

The Incentive Operating Fee Is	Number	Percentage
1%*	1	5%
1% after NOI is met	1	5%
1% after operating criteria net	1	5%
3.5% of NOI	1	5%
5% of gross operating profit	1	5%
5% of house profit	2	10%
5% of NOI & target NOI	1	5%
10% of adjusted net income after owners' preferred return.	1	5%
10% of adjusted operating income over a specific hurdle	1	5%
10% of cash flow after 8% owner return	1	5%
15% of NOI in excess of predetermined base line	1	5%
20% of adjusted operating profit after owner's preferred return of 11% on invested capital	1	5%
20% of available cash flow	1	5%
20% of gross revenue beyond budgeted	1	5%
20% of net income above an owner's priority. Above are post opening.	1	5%
Technical services preopening expense/ fee was $289,000 (hotel + condos)		
30% of NOI that exceeds feasibility study NOI	1	5%
Based on cash flow	1	5%
Determined as a % of "modified" GOP, and is subject to the availability of cash	1	5%
Varies, certain percent after an owner return	1	5%
Based on NOI: 30% to management company and 70% to owner	1	5%
Total	**21**	**100%**

Note. *Respondent indicated simply "1%."

TABLE 11. Preopening Costs Elements

Preopening Costs Included (56 Answered in Total)	Number	Percentage
Hiring and training costs	55	98%
Sales & marketing (advertising & promotion)	54	96%
Professional costs, such as legal fees	41	73%
Initial costs of operating supplies	38	68%
Salaries of executives involved prior to opening	37	66%
Grand-opening party	31	55%
Consulting costs	27	48%
Other	19	34%

of operating supplies in preopening costs. The results are revealed in Tables 11 and 12.

According to USALI, preopening costs should be expensed at the time of the opening of the property. Only 15 (27%) companies expensed preopening costs properly in accordance with the 9th edition, and five (9%) companies partially expensed preopening costs. Meanwhile, 35 companies accounted for preopening costs in other ways contrary to the 9th edition of USALI. They recorded them primarily as either current or other assets (see Table 13). These companies are writing off their preopening costs over a period of time after the hotel is opened. The period of expensing varies from 1 month to 15 years.

Only eight (23%) of the companies expensed preopening costs within 1 year. The remaining write off preopening costs over periods exceeding 1 year. Twenty companies write off preopening over 1 to 5 years, and six write off the expenditures over periods greater than 5 years (see Table 14).

Finally, respondents were queried regarding the accounts that were charged as the preopening costs were expensed. Table 15 includes responses from 32 executives. Fourteen (45%) charged amortization, whereas 9% charged depreciation. Another seven recorded the expense as a fixed charge or other account that appears to be below GOP. Therefore, 75% of the respondents to this survey are *not* charging accounts directly related to operations.

TABLE 12. Preopening Costs Elements – Other

Preopening Costs Included Other (Please Specify)
• Building, land, permits, landscaping, FF&E, finance fees, insurance costs, management fees, taxes
• Employee relocation, office rent, employee meals, F&B costs for trial feedings and staff training
• Franchise training
• Insurance, building permits, loan points, architect
• Land rent to airport authority
• License permits, temporary office, utilities, security, staff travel costs
• Loan interest, loan closing fees
• Office space
• Office space (short-term) for hiring, relocation, opening team wages and travel, opening PR, restaurant opening expenses
• Operating personnel salaries/wages prior to opening training supplies
• Preopening hotel payroll, opening team (help from other hotels), training, temporary office, security, licenses, dues, uniforms
• Preopening fees paid to third-party manager
• Reservation expense, preopening office rent/utility expenses
• Some operating equipment not included in supplies such as bell carts, laundry cart, corporate travel
• Travel
• Utilities
• Working capital, which typically covers the wages until enough revenue is generated

TABLE 13. Preopening Costs Accounts

The Preopening Costs Prior to Opening Were Accounted For as	Number	Percentage
Expense	15	27%
Expense and other	5	9%
Current assets	10	18%
Other assets	19	35%
Current assets and other assets	2	4%
Other	4	7%
Total Responded	**55**	**100%**

TABLE 14. Months Preopening Costs Expensed

If the Preopening Costs Were Recorded as Assets, Over how Many Months Are They Expensed?	Number	Percentage
1 month	3	9%
12 months	5	14%
36 months	4	12%
60 months	16	47%
72 months	1	3%
120 months	1	3%
180 months	4	12%
Total	**34**	**100%**

TABLE 15. Preopening Expense Accounts

If Preopening Costs Are Expensed Over Time, What Expense Accounts Are Charged?	Number	Percentage
Amortization	14	45%
Depreciation	3	9%
Preopening*	3	9%
Fixed charges	2	6%
Below GOP before EBITDA	1	3%
Owners costs (below EBITDA)	1	3%
Subtotal	24	75%
Deferred expenses	1	3%
Expensed as named	1	3%
Marketing, training	1	3%
Miscellaneous	1	3%
Operating supplies	1	3%
Salaries & wages, technology	1	3%
Wages, advertising	1	3%
Use cost seg. analysis	1	3%
Total	**32**	**100%**

Note. *Presumably after GOP.

This research revealed that many lodging companies do not account for preopening costs according to U.S. GAAP rules updated by the FASB or in accordance with USALI as follows:

1. Some costs included as preopening costs are not preopening costs.
2. Preopening costs are not being expensed at the proper time.
3. Preopening costs are not being expensed to the proper accounts.

Because accounting for preopening costs is often improper, the related management fees will most likely be impacted. In addition, financial information presented on lodging firms' balance sheets will most likely be improperly stated. Clear guidance is required for accounting for preopening expenses by lodging firms, and the 11th edition of USALI should include guidance that has been excluded from the current edition.

IMPLICATIONS FOR EDUCATORS AND PRACTITIONERS

First, this study provides educators with a range of preopening costs and the preopening costs as a percentage of total development costs, which can be shared with their lodging students, especially those enrolled in hotel development and advanced finance classes.

Second, this research reveals percentages for base operating fees and incentive operating fee structures. Because many hotels are currently managed, it is appropriate to educate hospitality students.

Third, in the discussion of financial statements, the hospitality financial management educators should consider discussing with their students preopening costs and the proper accounting for these costs.

Fourth, this study provides members of the revision committee of USALI with the current accounting for preopening, which appears to have not been the case for the 10th edition of USALI. This study should lead to a brief revisiting of this topic in the 11th edition and an emphasis on the proper accounting for preopening costs.

CONCLUSION

This study was conducted to clarify the ambiguity in accounting for preopening costs, because the 10th edition of the USALI provides no guidance in accounting for preopening costs. From this study, it is revealed that the majority of lodging firms are accounting for preopening costs contrary to proper accounting methods. Many firms accounted for non-preopening expenses as preopening costs or treated the preopening costs in various ways because of lack of guidance from USALI. As a result, it appears that the lodging industry needs more guidance for accounting for preopening expenses.

The majority of responding financial executives identified their properties as upper-midscale or midscale, and the vast majority of respondents also indicated that their properties had fewer than 200 rooms, imposing a limitation of this study. This limited sample cannot represent all the different types of properties. Further, future research should include privately developed properties to reflect a more representative industry practice in accounting for preopening costs.

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AUTHOR NOTES

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