



Hotel Capital: An Owner and Commercial Lending Look Behind the Numbers

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Overview

The divide between public company and private company reporting requirements is shrinking. And the emphasis stakeholders once reserved for the numbers - the income statement, statement of cash flows, and the like - is expanding to include a look behind regular financial reports. In the hotel industry, this expansion is significant to owners and banks with hotel-based commercial loan portfolios for two reasons: 1.) they can meet and get in front of the various new requirements, and 2.) they have an opportunity to cherry-pick from the operational and financial reporting best practices being generated by this trend.

A look behind the numbers reveals the business. All of it. So fundamental to any effort by owners and banks to evaluate the business from the top down is the ability to summarize specific information about the governance, operations, processes, and people of a hotel. This will allow hotel owners to ensure company financial reports are accurate, and provide them a basis for claiming operations will produce consistent results into the future. This means management must have mechanisms in place to control the process of financial reporting and their operations at large, safeguard assets, and reduce opportunities for fraud. Mechanisms that meet these objectives will provide greater operational insight to senior management and ensure that major initiatives, such as acquisitions, system implementations, or cost-cutting, are not forced at the expense of quality and accurate financial reporting.

When knowledgeable of and armed with reports about key hotel governance, operations, processes, and people, banks will have a richer basis for comparing the quality of prospective hotel loans with those already in their portfolio. As banks extend loans to hotels that have provided such information, their ongoing loan monitoring practices will then be able to efficiently identify changes at a hotel that increase the risk of default and proactively react to those changes. Because the focus of this monitoring is structural and operational, loan officers will have a much earlier warning system and not have to look for such problems only in financial and performance reports.



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“ Reform applicable to private hoteliers has materialized and will likely proliferate until the standards are in line with public company requirements.”

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Governance, defined as the process by which persons exercise authority and administer business, has been covered by the press in stories that too often draw parallels to "the Enron disaster" and the Sarbanes-Oxley legislation. Such references can be difficult to relate to in the hotel industry at first blush. However, hotel owners and commercial banks can use tenets of sound corporate governance to aid in operating the business and reducing the risk of loan default attributable to management missteps.

Governance - By the Numbers

Sound corporate governance creates value because it leads to higher levels of information integrity. As information integrity increases so does the certainty that company reports are accurate, and that operations will produce consistent results into the future. This makes the operations of a hotel more desirable to potential commercial lenders, attracting capital and even commanding premiums - or better financing terms - for the hotel. For example, according to McKinsey & Company, "...investors will pay as much as 28% more for the shares of well-governed companies...". And other research confirms "that better corporate governance is highly correlated with better operating performance and market valuation". Similar conclusions have been drawn from research conducted by The World Bank, Credit Lyonnais Securities Asia, Asian Corporate Governance Association, and members of the academic community.

Attention to corporate governance preserves value. According to a study of 1,600 firms conducted by GovernanceMetrics International, Inc., companies with the worst governance ratings over the past three years lost an average of 13% market value per year compared with a loss of 1.8% for all companies. The challenge for hotel owners is twofold: 1.) to ensure their portfolio of hotels have one standard for efficiency, financial reporting, and regulatory controls that are summarized and reported to senior management and the board, and 2.) to aptly communicate those summaries in the form of disclosures to shareholders and lenders. Such practice will decrease the likelihood of unintended process outcomes caused by fraud, operational failure, or lack of key-personnel depth.

Private and Public Regulations Align

New private company rules and regulations are putting non-public operators on the hook to increase disclosures to investors and lending institutions, eliminate conflicts of interest in operations, and formalize their governance. In fact, these regulations provide a great advantage to the investors and lending institutions, namely, a greater ease with which to hold private and public hotel owners accountable if they do not uphold their fiduciary responsibilities (see below, "Pereira v. Cogan").



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The public company arena addressed the wave of corporate malfeasance and failure that first made headlines with the crash of Enron and former public accounting firm Arthur Andersen by enacting reform legislation such as the Sarbanes Oxley Act (the "Act"). Hotel owners need only worry about the complete legislation in a limited, and important, number of cases (see sidebar "Private to Public Considerations").

However, reform applicable to private hoteliers has materialized and will likely proliferate until the standards are in line with public company requirements. Recent initiatives in this area include:

- > **July, 2004** - the American Institute of CPAs (AICPA) launches a web-based survey to poll private company stakeholders to determine if financial statements prepared for investors are sufficient.
- > **July, 2004** - the United Nations Environment Program (UNEP) is working with major institutional investors to develop globally recognized principles for protecting the planet and long-term shareholder value by integrating governance, environmental, and social concerns into investor and financial market considerations.
- > **March, 2004** - the AICPA Private Company Financial Reporting Task Force is established (www.aicpa.org). This body is expected to recommend financial reporting requirements that include robust evaluation of governance at private companies.
- > **June, 2003** - the GAO calls on auditors to do additional work in connection with testing and reporting on internal controls - an area critical in sustaining successful models of governance (www.gao.gov/govaud/pryb2003.pdf).
- > **May, 2003** - in *Pereira v. Cogan, et al.* (No. 00 Civ. 619 RWS SDNY, May 27, 2003; U.S. Dist. LEXIS 7818), Judge Robert W. Street's ruling may significantly expand the responsibilities and liabilities of private companies. The judge rules that directors at the bankrupt Trace International Holdings failed in their responsibilities by allowing Trace's chairman and controlling shareholder to drain company funds by drawing excessive compensation, loans, and dividends.
- > **January, 2002** - Certain Sarbanes Oxley sections apply directly to private companies:
 - o § 802 - Criminal liability for document destruction
 - o § 904 - Increased liability for white-collar crimes
 - o § 803 - Increased penalties for securities fraud
 - o § 806 - Liability for retaliation against whistleblowers
- > **January, 2002** - the GAO announces significant changes to the auditor independence requirements that cover federal entities and those organizations receiving federal funds (www.gao.gov).

“ By acting now, hotels can avoid the major impact of satisfying the requirements, all at once as currently felt in public companies. ” pg 4



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In public companies, the new audited internal control report will soon be on par with the traditional financial statements as a primary source of information



First, assess organizational risk. Second, analyze the reliability and adequacy of the operations. Third, conduct detailed analytical procedures on historical transactions to identify and quantify errors. pg 5

about a company. There will be no reason to buy public company shares without formal regard to that company's governance and underlying business processes.

Likewise, there is no reason to overlook this information in the private company world. Hotel owners that assess and report on key features of governance will be in a better position to allay investor and bank concerns, to drive efficient and controlled business processes, and to enhance the accuracy and transparency of accounting and financial reporting. By acting now, hotels can avoid the major impact of satisfying the requirements, all at once, as currently felt in public companies.

Governance Framework - Background

Banks must be able to trust that four primary objectives are met at a target investment:

- > Financial reporting is accurate and transparent
- > Assets are safeguarded
- > Business processes are efficient and controlled
- > Policies / procedures ensure the execution of sound governance

In implementing practices to meet the objectives above, firms should not start from scratch but should take into consideration existing public company efforts to comply with the Act that are producing extensive governance-related methodologies. Remember, the Act shifts focus to the events and environment leading up to financial statement generation. Aspects of the Act require certain COSO considerations, a model providing a unified definition of control over 19 years ago.

To establish a framework suitable for hotel use, begin with a proven model that has been used extensively to assess governance in both public and private companies:

1. Identify financial, operational, and compliance related objectives
2. Deconstruct business processes into discrete tasks prioritized by significance and risk
3. Assess system-based and manual activities designed to satisfy entity and process-level objectives
4. Compare actual activities to documented activities to optimum activities and rate gaps by impact to the organization
5. Analyze historical transactions to identify and quantify non-conforming transactions

Once these steps have been executed, practitioners should identify individually significant deficiencies and thematic deficiencies in the governance architecture. This is the framework applicable to private companies - for achieving sound governance and information integrity - writ large.





“ Traditional due diligence will not be enough: it limits organizational understanding to the financial outputs of a company. ” pg 6

By distilling the five steps above into three phases, an industry-neutral, private company assessment approach is established: the Operational & Financial Analysis. This can then be used on an as-needed basis at portfolio companies. Regularly executing this assessment will keep your thumb on the pulse of operations, and best of all, demonstrates that the hotel has taken the necessary measures to fulfill its responsibility, i.e. a wider range of business outcomes are more defensible from litigation in the event that unforeseen problems arise that negatively impact financial reporting.

The Framework - Three Phases

Phase 1 - Risk Assessment

First, assess organizational risk. This involves meeting with senior management, reviewing existing policy, process and procedural information, and analyzing current oversight mechanisms at a high-level. On the governance side, this means looking at the extent to which oversight activities are integrated and kept free of conflicts of interest. Regarding business operations and infrastructure, this means assessing four organizational characteristics: business and system complexity, existence and custody of assets, control structure performance, historical results of incurred risks and action plans. Recommendations in this phase identify areas for further detailed analysis.

Phase 2 - Operational Assessment

Second, analyze the reliability and adequacy of the operations. The goals in this phase are to address noted risks and improve the operating environment. Here, processes are deconstructed into discrete tasks where objectives must be met through coordination of manual, system, preventive, and detective controlling activities. Inspection of major asset categories (e.g. cash receipts, disbursements), accounting, and financial reporting yields a prioritized gap analysis for decision makers. This way, where assets are not protected or key processes are not well-governed, the costs of not taking action can be weighed against the costs of gap remediation.

Phase 3 - Transaction Analysis

Third, where key business activities are weak, conduct detailed analytical procedures on historical transactions to identify and quantify errors. Root-cause analysis is performed to determine whether non-conforming transactions are attributable to process design, control failure, fraud, or system integrity.

With cost-efficient and tactical application of the governance methods being proven in public companies, private investment evaluations and monitoring practices can create and preserve value.



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“ The average fraud in a small company results in a loss of \$127,500 and the average financial statement scheme is a \$4.25 million. ”^{pg 7}

Link to Hotels

At the 26th annual New York University International Hospitality Industry Investment Conference held in June this year, numerous presenters reinforced the significance of the 6% growth rate - or \$33 billion increase - predicted for world travel this year. For starters, the rebound will make it easier to raise capital. For example, PricewaterhouseCoopers "...is sticking to its forecast earlier this year that such transactions [IPOs] would be on pace to raise more than \$1 billion in equity in 2004." The net result of industry players, big and small, raising such funds will be an increase in investors: more eyes will review the financials and more eyes will monitor performance. Meaning, fiduciary obligations will extend to a growing investor pool and those obligations will be held to standards set higher than ever before.

Traditional due diligence will not be enough: it limits organizational understanding to the financial outputs of a company. Little is revealed in terms of how those outputs came to be. Were the financial results a stroke of luck? Are they repeatable? Or were the financial statements manufactured in corrupt and fraudulent schemes?

By knowing more about the business behind the numbers, hotel owners, commercial lenders, and the public can make better funding, acquisition, and investment decisions. More importantly, these parties will have a basis for monitoring and reporting on their investments as they grow.

A) ABC Hotel Ltd - Case One

1. The Scenario

ABC Hotel Ltd is the real estate investment arm of a large resort and real estate company. Executing a hotel portfolio expansion and acquisition strategy focused on every market segment in both North America and Asia, ABC Hotel Ltd will complete 3 major transactions by year-end.

2. The Challenge

The portfolio hotels operating abroad are encumbered by antiquated systems and an inefficient governance structure. For example, key aspects of financial reporting are performed with applications outside of the primary accounting system, and few procedures exist to implement and review operational issues when corrective action plans are developed by management. Costs associated with aligning the foreign hotels' standards with those of the hotels currently owned by ABC Hotel Ltd were initially unknown.

3. Sound Governance

ABC Hotel Ltd is committed to rationalizing governance and operational practices at all of its portfolio hotels; it demands one standard for oversight and monitoring. Through the Operational & Financial Analysis, variations in





accounting, revenue management, and high risk operations at each target hotel were identified and analyzed for management. Because ABC Hotel Ltd relies heavily on the summary reports it receives from each individual hotel to make decisions, all uncontrolled operations and performance reporting practices will be reengineered.

4. Results

Costs associated with integrating the hotels' operations with existing policies, system controls, and customer service standards at ABC Holding Ltd were identified. Armed with this information, ABC Hotel Ltd was able to negotiate better acquisition terms with the sellers.

One Step Further

According to another McKinsey & Company study, "... the most critical requirement in corporate governance is raising the quality of the strategic dialogue between the board and management. To do so, both sides must see timely information that shows a company's progress in implementing its strategy" At the board, executive management, or partner level, there is no shortage of information to be digested. Given the number of sources this information comes from, data must be valid, timely, customized, and disseminated.

“ What’s ahead is a stasis in which assessments of and reporting on governance is not only common, but expected.”

As the next case illustrates, there is no greater danger for a relatively small firm than to be compromised by specific - preventable! - governance weaknesses. And although this case references a Nigerian letter scam - a fraud that is hard to imagine still taking place - the story is true. In fact, the average fraud in a small company results in a loss of \$127,500 and the average financial statement scheme is \$4.25 million.

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B) LegalCo., A Law Firm - Case Two

1. The Client

LegalCo. is a trusted advisor to its clients; it often assists on matters related to compliance and asset protection. Also, the firm serves as custodian for various client settlement payments.

2. The Challenge

In January, 2002, LegalCo.'s Bookkeeper received a fax from a person claiming to be Dr. Mbuso Nelson, an official with the ministry of Mining in South Africa. Dr. Nelson offered to pay her a \$4.5 million fee to help him transfer \$18 million from South Africa to the United States. This instance of The Nigerian Letter scam convinced the Bookkeeper to fraudulently wire \$2.2 million from her law firm's bank accounts to unauthorized accounts in South Africa and Taiwan.



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3. Sound Governance

A well-functioning model of governance could have prevented this large loss to the relatively small law firm. The Certified Fraud Examiners 2002 Report to the Nation on Occupational Fraud and Abuse estimates fraud related losses at approximately 6% of GDP - \$600 billion annually. And as it turns out, it is the smaller firms that suffer the highest median fraud losses. Small staffs often lack basic internal controls, e.g. a single person is responsible for payment of invoices, check production, counting cash, and reconciliation of the bank statements.

4. Results

"Strong internal controls", as identified in the Report, are the single most powerful deterrent to occupational fraud. In 46% of the cases examined, fraud occurred because insufficient controls were in place within the organization. Remediation efforts to ensure those controls are incorporated into LegalCo's overall governance structure are ongoing.

No company - whether due to small staffs, rapid periods of growth, competing priorities, complex operating environments, or ignorance - should have to find out the importance of safeguarding assets only after a severe loss has taken place.

Time to Plan

Business as usual is not an option for public companies; the Sarbanes Oxley Act and the creation of the Public Company Accounting Oversight Board ensured as much. But reform is never easy, especially when public companies are trying to fight the two-front war of education and implementation. Education is a challenge because honest assessments of governance involve the organization, from the top down. The tight deadlines set forth in the Act meant companies had to begin their compliance initiatives before everyone knew what exactly the obligations entailed.

With the press continuing to run headlines of business failure and executive convictions, there is enough momentum in the private company world to leave the status quo behind. What's ahead is a stasis in which assessments of and reporting on governance is not only common, but expected.

Sound governance and a resultant boost to information integrity are a must in attracting capital and avoiding litigation. Hotel owners and commercial lenders should use this time to learn more about COSO, process and control models, related information systems, and additional benefits that can be derived from such broad and in-depth business understanding.



**Sidebar: 'Private to Public Considerations'**Sarbanes Oxley Act Triggers

- > Filing a registration statement under the Securities Act of 1933
- > Private companies with registered debt securities
- > Initial Public Offering with a market capitalization greater than \$75 million (IPOs under that cap have a one year reprieve and are not subject to the entire legislation of the Act until 15 July, 2005)
- > Acquisition by a public company

Challenges

- > Identifying and recruiting independent directors
- > Establishing independent audit committees and designating a financial expert
- > Designing and documenting financial and disclosure controls
- > Adopting and implementing policies to avoid conflicts of interest
- > Providing a functioning whistleblower process to all employees
- > Establishing processes to identify control deficiencies, evaluate those deficiencies, and follow-through with timely corrective action plans
- > Ensuring the independent accountants are not providing any impermissible non-audit services
- > Implementing anonymous reporting facilities and procedures to appropriately address reports

