

Financial Reporting Center – Revenue Recognition

Working Draft: Hospitality Revenue Recognition Implementation Issue



Issue #7-2 - Accounting for Revenues in a Hotel Management Service Arrangement

Expected Overall Level of Impact to Industry Accounting:

Moderate

Wording to be Included in the Revenue Recognition Guide:

1. A hotel management and franchising company (“Manager”) may sell hotel management services without a hotel system IP license (e.g. to an independent hotel or a third party branded hotel – “Owner”) and charge the Owner base and incentive management fees for those services and is reimbursed for certain costs incurred (e.g. employee payroll). Alternatively, the Manager may also bundle the hotel system IP license as well as hotel management services and charge the Owner all fees previously outlined, as well as royalty fees, for both the management services and license of IP. Based on the specific facts and circumstances, the fees charged by the Manager (e.g. license royalty, base, and incentive fees) may be calculated on different revenue bases (e.g. gross room revenues, total revenues, or gross operating profit).

Step 1: Identify the Contract

Contract Combinations

2. A hotel management arrangement may include several agreements that are generally negotiated at the same time with the same counter-party. Historically, these contracts have typically been combined. FASB ASC 606-10-25-9 states that an entity should combine two or more contracts entered into at or near the same time with the same customer (or related parties of the customer) and account for the contract as a single contract if one of more of the following criteria are met:
 - a. The contracts are negotiated as a package with a single commercial objective.
 - b. The amount of consideration to be paid in one contract depends on the price or performance of the other contract.
 - c. The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation.
3. While the specific facts and circumstances of a given transaction should be considered, FinREC believes that the ancillary agreements executed with a hotel management agreement (e.g. pre-opening or centralized services, license agreement) will meet the criteria in FASB ASC 606-10-25-9, and should be combined and accounted for

as a single contract. The combined contract should then be reviewed to identify if there are separate performance obligations under FASB ASC 606-10-25-14.

Scope Considerations

4. In customary hotel management agreements, the Manager promises to provide hotel services to guests (e.g. room access, food and beverage services, housekeeping services, security, etc.) and earns fees from the Hotel Owner for the services it provides. Prior to evaluating the contract in the context of FASB ASC 606, the Manager should evaluate the management agreement in order to determine whether either the agreement represents a lease, and would therefore be accounted for in accordance with FASB ASC 840 (or FASB ASC 842 once adopted) or whether the management agreement with the Hotel Owner legal entity results in the Manager being the primary beneficiary of a VIE based on the guidance within FASB ASC 810. If the Manager determines that the management agreement is not a lease and the management agreement does not result in the Manager being the primary beneficiary of a VIE, then the Manager should then evaluate the accounting for the agreement in accordance with FASB ASC 606.

Principal versus Agent Analysis

5. Under FASB ASC 606, the Manager should consider whether it is acting as a principal or agent when providing goods/services to hotel guests in order to determine whether its customer is the Owner (Manager is agent), or the hotel guest (Manager is principal). A key factor in the determination of whether the Manager is a principal or an agent is whether the Manager controls the specified goods or services prior to the transfer to the hotel customer both per the terms of the management agreement and in practice.
6. FASB ASC 606-10-55-37 states “An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer.” FASB ASC 606-10-55-37 also states that, “An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of a performance obligation on its behalf.”
7. Example Scenario - The following example is meant to be illustrative, and the actual determination of the application of ASC 606 should be based on the facts and circumstances of an entity’s specific situation. The following example fact pattern is used throughout this document.

Company Background:

The hotel management and franchising company (“the Company”) licenses its brand and related hotel system intellectual property (“IP”) to franchisees without management services and charges the licensee a royalty fee. The Company also sells the hotel management services without a hotel system IP license (i.e. to an independent hotel or a third party branded hotel) and charges the Owners base and incentive management fees for those services and is reimbursed for certain costs incurred (e.g. employee payroll).

Further, the Company also bundles the hotel system IP license as well as hotel management services and charges the hotels all fees previously outlined for both the license of IP and management services. On occasion, the Company discounts or waives the royalty fee when the license is bundled with a management agreement.

Contract Details:

The Company enters into a 20-year management agreement to operate a newly-built hotel for the Owner under one of the Company’s brand names. The hotel is located in a market with both seasonality and significant local competition. The Company executed the contract on January 1, 20X0, prior to the hotel’s construction, and the hotel opened on January 1, 20X2. The Manager did not perform any services prior to opening. Key elements of the management arrangement include the following:

- a. The Owner has selected the brand name under which the hotel will be operated;
- b. The Manager executes all contracts in the name of and on behalf of the Owner;
- c. The Owner provides the pre-opening funds and all working capital;
- d. The Owner has budget approval rights over the operating and capital budget rights;
- e. The Manager’s fees are not directly affected by credit losses.

Additionally, the promises made to the Owner via the Hotel Management Agreement include the following:

- Promise: Provide a license to use the Company's hotel brand name and related marks and access the Company's proprietary hotel system intellectual property (collectively referred to as "the hotel system IP"), which includes the reservation system, mobile applications and property management software over the agreement term. (Refer to the Franchise Fees Paper for further discussion of associated promises.)
 - Charging Mechanism: License Royalty Fee based on Sales. (Refer to the Issue #7-1: *Franchise Fees*, for further discussion of other fees that may be charged.)
- Promise: Manage the hotel operations on behalf of the Owner based on the terms of the Management Agreement.
 - Charging Mechanism: Base and Incentive fee based on hotel performance.
- Promise: Provide hotel employees and centralized accounting services.
 - Charging Mechanism: Reimbursement of costs incurred.

Principal versus agent analysis:

In order to determine the principal in the transaction with the hotel guest, in accordance with FASB ASC 606-10-55-37, the Manager should consider which entity controls the specified good or service before it is transferred to the customer. FASB ASC 606-10-55-39 provides the following indicators that an entity controls the good or service before it is transferred to the customer, and is therefore a principal:

- a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service.

In this example, the Owner is primarily responsible for fulfilling the contract to the hotel guest and directs the Manager to provide the services. The Manager executes contracts in the name and on behalf of the Owner in order to provide the services to the guests. The Owner is responsible for ensuring the hotel has the appropriate level of working capital and has budget approval over operating and capital expenditures to ensure the Manager can adequately provide the services and rooms to the guests, as such the Owner would generally be deemed to be primarily responsible for fulfilling the contract with the hotel guest (e.g. the reservation). Therefore, this fact pattern indicates an agency relationship.

- b. The entity has inventory risk before the specified good or service has been transferred to a customer.

In this example, the Owner holds "inventory" risk. While the fees it earns will be lower, the Manager does not have a risk of loss if the rooms are unoccupied or the building is damaged. Therefore, this fact pattern indicates an agency relationship.

- c. The entity has discretion in establishing the price for the specified good or service.

In this example, the Manager provides revenue management services as part of the hotel management services, but the prices are constricted to a limited range determined by the decisions controlled by the Owner. The Owner initially controls the range of prices that can be charged to the hotel customer through its selection of a hotel brand and location. Further, through the approval of the operating and capital budgets, the Owner controls the physical condition of the hotel and the level and quality of services provided to hotel guests which will further influence the range of prices the hotel can charge. While the Manager may ultimately select the exact dollar amount of the prices charged through its revenue management services, the Manager's selection of the prices would be constrained by the factors controlled by the Owner outlined above. Therefore, this fact pattern indicates an agency relationship.

In this example, FinREC believes the Management Agreement and other ancillary agreements represent a single contract in accordance with FASB ASC 606-10-25-9. In the consideration of the services provided to the hotel guests, FinREC believes that the Manager does not control these services and therefore the Manager's promise is to arrange for goods or services to be provided to the hotel guests on behalf of the Owner, as the Owner's agent. The Manager's customer is the Owner.

Step 2: Identify the Performance Obligations

8. Within the context of a typical management agreement, there are several promises made to the Owner that, in accordance with FASB ASC 606-10-25-14, should be analyzed to determine if they are distinct, and therefore separate performance obligations, within each management agreement. The following is a non-comprehensive list of some of the promised services that may be included in a hotel management agreement:

- a. Promises related to arranging for the provision of services to hotel guests (e.g. room access and security, housekeeping, food and beverage, in room entertainment, etc.) on behalf of the Owner. Examples include, but are not limited to:
 - i. Provision of hotel employees for hotel operations (Management, housekeeping, front desk, food and beverage, on-site accounting, etc.)
 - ii. Centralized accounting or other shared services
 - b. Granting the right to use the Manager's hotel system intellectual property ("hotel system IP") over the term of the agreement. The hotel system IP may include the brand name and related trademark, reservation system, and property management software. (Refer to the Franchise Fees Paper.)
 - c. Providing consultation services over the hotel pre-opening period (pre-opening services and/or brand oversight).
 - d. Other ad-hoc services (e.g. purchasing services).
9. Based on the specific facts and circumstances, the Manager should determine if any of the promises included within the management agreement are more indicative of a fulfillment activity of another promise versus a separate promise.

Step 2A: Identify the Distinct Goods or Services Promised Within the Contract.

10. The Manager should determine if the promises are distinct and should be accounted for as separate performance obligations. FASB ASC 606-10-25-19 states that the following two criteria need to be met in order for a good or service to be "distinct:"
- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
 - b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).
11. In order to identify the distinct goods or services promised within the context of a typical management agreement, the Manager should first identify the promises that are capable of being distinct. For each of the promises identified, the Manager should typically then consider if the promise is separately identifiable within the context of the contract being evaluated.

Step 2A.a: Identify the Promised Goods or Services that are Capable of Being Distinct

12. In a typical management agreement there are several promises provided to the Owner that should be analyzed to determine if they are capable of being distinct. For illustration refer to items 1 through 5 of the example.
13. The Items promised to an Owner through a hotel management agreement may vary based on the needs of the Owner, the local market, brand of hotel, etc. Likewise, the fee structure of a hotel management agreement will vary as well. Because services and fee structures vary from arrangement to arrangement, a careful review is needed in order to understand whether the services or bundle of services would likely be capable of being distinct.
14. If the Manager or its industry peers routinely sells any of the goods and services specifically outlined within the management agreement separately to other Owners, the promised goods and services are generally capable of being distinct in accordance with FASB ASC 606-10-25-19(a) as long as the Owner can both benefit from the goods and services either on their own or together with other readily available resources and generate economic benefit from the individual goods and services by using or consuming those goods or services on their own. This may be further corroborated if the Manager, or its industry peers, regularly charges a separate fee for each of these goods and services or bundle of goods and services.

Assessment of the Considerations for Step 2A.a

15. FinREC believes that the goods or services (or bundle of goods and services) that the Manager or its peers separately sell to Owners (noted in the Items above) are generally capable of being distinct and therefore meet the criteria in FASB ASC 606-10-25-19(a).

Step 2A.b: Identify Whether Promises to Transfer Goods or Services that are Capable of Being Distinct are Separately Identifiable from Other Promises in the Contract (i.e. are distinct within the context of the contract)

16. In order to determine the distinct services within a typical management agreement as defined in FASB ASC 606-10-25-19, the Manager should also consider whether the service(s) identified as capable of being distinct are also separately identifiable from other promises in the contract (i.e. distinct within the context of the contract). Meaning, the Manager should consider whether the nature of its promise is to transfer each of the goods or services or whether the promise is to transfer a combined item (or items) to which the promised goods and/or services are inputs.
17. In order to aid companies in performing its assessment of whether the promised goods or services within an arrangement are not separately identifiable, FASB ASC 606-10-25-21 provides the following factors that indicate that two or more promises to transfer goods or services are not separately identifiable, noting that the following is not all inclusive:
- The entity provides a significant service of integrating the goods or services with other goods or services promised in the contract into a bundle of goods or services that represent the combined output or outputs for which the customer has contracted. In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. A combined output or outputs might include more than one phase, element or unit.
 - One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by one or more of the other goods or services promised in the contract.
 - The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.
18. The following describes key considerations when applying the guidance in FASB ASC 606-10-25-21 to the example:

- Hotel management services promise (e.g. Item 1 as previously outlined): In a typical hotel management agreement, the overall nature of the promise is to arrange for the provision of services to hotel guests on behalf of the Owner (e.g. rooms, housekeeping, food and beverage, in room entertainment, etc.) over the agreement term. Often the negotiated contractual promises include discrete hotel management and operational functions such as the employment of hotel employees, revenue management, centralized accounting services, and other. Depending on the management contract, these services may not be considered separately identifiable if the Manager provides a significant service of integrating the services (the inputs) into the overall hotel management service (the combined output) for which the Owner has contracted.

Additionally, Example 12A in FASB ASC 606-10-55-157C through 55-157D, clarifies that while the Manager's underlying activities will vary both within a day and day to day, the Manager is providing a daily management service that is distinct and substantially the same.

- Hotel System IP license promise (e.g. Item 2 as previously outlined): A hotel system IP license may be embedded in or executed separately (but simultaneously) with a hotel management agreement. As discussed in the Franchise Fees Paper, the bundle of promises associated with a franchise license represents a single distinct promise. The Manager must further consider whether the license is distinct from the hotel management services. Considerations that indicate the hotel system IP license and the hotel management services are separately identifiable and therefore "distinct" would typically include:
 - The hotel management services and the hotel system IP license do not each significantly modify or customize the other;
 - The Manager can satisfy each of the promises in the contract independently of the other;
 - The Owner can readily obtain either the hotel management services and/or hotel system IP from other entities; and
 - There is a promise to provide hotel management services that do not significantly affect the customer's ability to derive benefit from the hotel system IP license.
- Pre-opening Services promise (e.g. Item 3 as previously outlined): In the instances where the Manager collects a fee in advance of hotel opening, the evaluation of whether the Manager's activities prior to the hotel opening transfer a service to the customer that is distinct from the hotel management promises will need to use judgment which may vary based on the individual contract needs and the Manager's customary business practices. Considerations that would indicate that the activities do not transfer a service to the Owner during the pre-opening period might include:

- i. The services do not create or enhance an asset (i.e. the Hotel) that the Owner controls as it is created or enhanced;
- ii. The Owner does not simultaneously receive and consume the benefits as the Manager performs; and
- iii. The Manager's performance does not create an asset without an alternative use for the Manager and the Manager does not have an enforceable right to payment.

If the Manager determines its pre-opening services transfer a service to the Owner, it should then consider whether that service is separately identifiable from the overall hotel management promise. A key consideration in that assessment is whether the pre-opening services and hotel management services each affect the other and whether the Manager could fulfill its promise for one independently of the other.

If the Manager concludes the activities do not transfer a service to the Owner; the Manager would typically disregard the activities for the purposes of identifying the performance obligations. If the Manager concludes the activities do transfer a service to the Owner, but the service is not separately identifiable from either the hotel management or hotel system IP promise, the Manager would typically bundle the services with that promise for the purpose of identifying and accounting for the performance obligation. Finally, if the Manager concludes that the activities do transfer a service to the Owner, and this service is separately identifiable and therefore distinct, the Manager would typically account for the service as a separate performance obligation.

- d. Ad-hoc services promise (Item 4): Other discrete goods or services promised by the Manager may be separable from the hotel management services and/or hotel system IP. These discrete goods or services may be performance obligations specifically included in the management services contract, optional goods or services listed in the contract, or may be negotiated at a later time as a contract modification. Based on the specific facts and circumstances, "ad-hoc" service promises may be separately identifiable when evaluated based on the principle and the factors in FASB ASC 606-10-25-21. Considerations that would indicate the promises are separately identifiable may typically include:
 - i. The "ad-hoc" service promise does not significantly modify or customize another promise;
 - ii. The Manager is not providing a significant service of integrating the service promise and the other promises into a combined output;
 - iii. The "ad-hoc" promises are not highly interrelated or highly interdependent if the Owner's ability to use and benefit from the "ad-hoc" promise is not significantly affected by any of the other promises and if the Manager can fulfill its contractual obligation to provide the "ad-hoc" service promise independent from its other promises; and
 - iv. The "ad-hoc" service promise would not significantly affect the Owner's ability to use and benefit from the remaining promises as it is not complex and can be obtained from alternative providers to the extent the Owner cannot perform the service themselves.

Assessment of Considerations for Step 2A.b

- 19. The services or bundle of services for which the Owner is charged a separate fee are generally capable of being distinct and may be separately identifiable when combined with other items within the criteria in FASB ASC 606-10-25-19(b) (see further discussion in Step 2B). Within a typical branded hotel management agreement, FinREC believes that the Manager will identify two series of distinct services or bundle of services related to arranging for the provision of services to hotel guests on behalf of the Owner as well as the license that provides a right to access the a hotel system IP. Based on the evaluation of the remaining promises of the contract, the Manager may conclude there are additional "ad-hoc" performance obligations as well.

Step 2B: Identify which of the Distinct Promises Identified in Step 2A Represent Separate Performance Obligations

- 20. Once the Manager has identified the distinct promises or bundle of promises provided within a management agreement within Step 2A, the Manager should then identify the associated performance obligation. In accordance with FASB ASC 606-10-25-14, a performance obligation is either:
 - a. A good or service (or a bundle of goods or services) that is distinct; or
 - b. A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer.
- 21. FASB ASC 606-10-25-15 further states:
 - A series of distinct goods or services has the same pattern of transfer to the customer if both of the following criteria are met:

- a. Each distinct good or service in the series that the entity promises to transfer to the customer would meet the criteria in paragraph 606-10-25-27 to be a performance obligation satisfied over time.
 - b. In accordance with paragraphs 606-10-25-31 through 25-32, the same method would be used to measure the entity's progress toward complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.
22. As explained in paragraph 29 of Issue #7-1: *Franchise Fees*, FinREC believes the promise to provide the License (License to the Franchisor's intellectual property) is a series of distinct services that represents a single performance obligation. Further, as described in Example 12A, FASB ASC 606-10-55-157C through 55-157D the series of hotel management services would represent a separate performance obligation that is made up of a series of distinct services performed over time.
23. The Manager should then analyze the remaining "ad-hoc" distinct services included within the contract to determine the associated performance obligation.
24. Example Scenario - The following example is meant to be illustrative, and the actual determination of the application of ASC 606 should be based on the facts and circumstances of an entity's specific situation. The following example fact pattern is the same used throughout this document (see paragraph 7).

Step 2 Analysis

The Manager first evaluates each of the promises previously described in the Contract Details and determines that they are each capable of being distinct as the Owner can benefit from the services either on their own or together with other resources that are readily available (i.e. it can obtain a franchise license or hotel management services from another company).

The Manager then reviews each of the promises to determine the associated performance obligation:

- Promise:
Provide a license to use the Company's hotel brand name and related marks and access the Company's proprietary hotel system intellectual property, which includes the reservation system, mobile applications and property management software over the agreement term. (Refer to Issue #7-1: *Franchise Fees*, for further discussion of associated promises.)
 - Performance Obligation: Daily right to access hotel system IP License, (series of services forms single hotel system IP license performance obligation).

Refer to discussion within paragraph 22 for discussion related to the determination this promise is distinct. Refer to the Issue #7-1: *Franchise Fees*, for further discussion regarding the identification of the related performance obligation.

- Promise:
Manage the hotel operations on behalf of the Owner based on the terms of the Management Agreement. Provide the hotel employees and centralized accounting services.
 - Performance Obligation: Daily hotel management, (series of services forms single hotel management performance obligation)

Distinct within the context of the contract analysis: Employment and centralized accounting services are inputs to produce a combined output (the hotel management services).

Series distinct services analysis: BC 285 of FASB ASU No. 2014-09 clarifies that while the Manager's underlying activities will vary both within a day and day to day, the Manager is providing a daily management service that is the distinct and substantially the same.

Step 3: Determining the Transaction Price

License and Royalty Fees

25. Refer to Issue #7-1: *Franchise Fees*, for discussion regarding the transaction price related to the hotel system IP license.

Principal vs. Agent (Gross versus Net)

26. FASB ASC 606-10-32-2 states:

An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts or both.

27. The Manager receives base and incentive fees for the services provided to the Hotel Owner. Additionally, the Manager typically charges several other fees to the Owner for costs it incurs in providing those services. The Manager should evaluate the specified good or service to ensure they are associated with the promises to the Owner for which it is the principal versus an ad-hoc promise for which it is the agent of the third party prior to including the fee in the estimate of the transaction price.

Significant Financing Component

28. On occasion, the contract may include upfront payments and/or extended payment terms for the associated fees (e.g. a subordinated management fee). The Manager should evaluate the payments in accordance with FASB ASC 606-10-32-15 through 32-20 in order to determine if these payment terms are indicative that the arrangement contains a significant financing component. If the Manager concludes that there is a significant financing component, in accordance with FASB ASC 606-10-32-15, the Manager would adjust the promised amount of consideration such that the transaction price reflects the time value of money. The Manager should also evaluate the effect the financing component might have on financial statement presentation.

Fixed Fees

29. At the inception of the contract, there may be certain fixed fees in the agreement (e.g. a pre-opening services fee) that might be included in the transaction price. Amounts that are fixed per the contract terms may in fact be variable if the Owner has a valid expectation arising from the Manager's customary business practices that it will provide a fee concession or other facts and circumstances indicate the Manager intends to provide a concession. For example, if the contract contains a fixed pre-opening fee, the Manager should consider whether it has a history of waiving all or a portion of that fee and if so, would consider the fee variable for the purposes of estimating the transaction price. If the Manager determines the fee is in fact variable, it should consider the guidance in FASB ASC 606-10-32-11 through 32-13 on constraints on variable consideration in determining the amount to include within the transaction price at contract inception.

Variable Consideration

30. The non-license hotel management fees based on a percentage of the hotel's revenues and profit are variable. As management agreements typically do not outline specific activities the Manager will perform (e.g. a specified amount of labor hours at a rate per hour), the reimbursable fees are also variable since the amount is not known at the beginning of the contract and the amount that the Manager will be entitled to changes based upon the requirements to fulfill the contractual promises each day. Therefore, as the majority of fees associated with a typical hotel management agreement are variable consideration, the estimate of the transaction price associated with these non-royalty license fees (e.g. base fees, incentive fees, and reimbursed fees) should be determined in accordance with the guidance on variable consideration and constraining estimates of variable consideration in FASB ASC 606-10-32-5 through 32-13.
31. FASB ASC 606-10-50-14A provides a practical expedient that allows companies to not disclose the estimate of revenues related to variable fees that are allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation in accordance with paragraph 606-10-25-14(b), for which the criteria in paragraph 606-10-32-40 have been met. As discussed in paragraphs 36 through 38 below, the allocation of the transaction price to services that have been performed is limited to the actual fees earned to date based on the contract terms. Therefore, any estimate of the transaction price associated with future services that will be provided under the contract would be allocated to wholly unperformed services within the series and would meet this disclosure practical expedient. Therefore, the Manager would not need to include an estimate of variable fees that will be earned in future periods in the transaction price as these fees would neither be recognized nor disclosed.

Constraining Estimates of Variable Consideration

32. In accordance with FASB ASC 606-10-32-11, once actual fees have been earned based on the underlying hotel activity (refer to example below), a Manager should only include amounts of variable consideration in the transaction price to the extent it is probable that a significant reversal in the cumulative amount of revenue

recognized would not occur when the uncertainty associated with the variable consideration is subsequently resolved. This constraint would primarily apply to incentive fees, which vary based on hotel profit over a defined period that may extend past the current period. Typically other fees earned by the Manager are not refundable based on future hotel performance. However, the Manager would also need to consider any anticipated refunds or concessions it will provide on any fees earned to date.

33. FinREC believes that the following are factors that could increase the likelihood or the magnitude of a revenue reversal include:
- a. Management agreements are typically long term in nature. While a Manager may have experience with similar contracts, the experience is of little predictive value over the long term;
 - b. The promised consideration related to the hotel management obligation is highly dependent on the hotel's specific market conditions and will be influenced by factors outside of both the Owner's and the Manager's influence such as economic, social, political, and natural forces;
 - c. Further, the promised consideration related the hotel management obligation is highly dependent on the Owner's budget and other decisions, such as their willingness and ability to make capital improvements to the hotel; and
 - d. The amount the Manager will earn has a large number and broad range of possible outcomes.

Updating the estimate of transaction price at each reporting period

34. In accordance with FASB ASC 606-10-32-14, at each reporting date the Manager should update its estimate of the transaction price associated with the base and incentive fees as well as fees for the hotel management and operational functions in accordance with the example in FASB ASC 606-10-55-221 through 55-225.
35. At the end of each period, based on the specific facts and circumstance the Manager will include in the transaction price the actual amount of the base fees for the hotel management and operational functions billable, unless it anticipates a fee refund or concession will be provided, because the uncertainty is resolved and it is probable that a significant reversal in the cumulative amount of revenue recognized would not occur.
36. The Manager may also conclude that it can include in the transaction price the actual amount of the incentive fees due under the contract terms (even if it does not have an enforceable right to payment at that specific point in time), as long as it is probable the fees will not reverse in subsequent periods. For instance, if the property has seasonality where it earns a significant profit in the first part of the year that historically gets fully or partially eliminated by unprofitability in the last six months of the year, the Manager **would most likely not** include the entire billable incentive fee in the current period transaction price even if the Manager had an enforceable right to bill and collect incentive fee in the first part of the year. Further, if the Manager has concluded it is probable the Owner will terminate the contract within the incentive fee period, it would most likely constrain the transaction price to the amount to which it has an enforceable right to payment.
37. The Manager will not include an estimate of the future variable fees that will be earned under the remaining contract as these amounts will neither be recognized nor disclosed.
38. Example Scenario - The following example is meant to be illustrative, and the actual determination of the application of FASB ASC 606 should be based on the facts and circumstances of an entity's specific situation. The following example fact pattern is the same used throughout this document.

Contract Execution and Hotel Opening

At contract inception and hotel opening, the Manager concludes that the guidance in ASC 606-10-55-65 regarding sales-based and usage-based royalties promised in exchange for a license of intellectual property would be applied to the hotel system IP license (refer to paper 7-1, Franchise Fees) as that is when the subsequent sale or usage occurs and when the performance obligation has been satisfied. Additionally, the Manager will not include an estimate of the future variable fees that will be earned under the contract as these amounts will neither be recognized nor disclosed.

Month 1

During month 1, the Manager, for example, would update its estimate of the transaction price as follows:

Fee	Calculation	TP Estimate @ Hotel Opening	Hotel Activity (Revenues/GOP/ Costs) Earned/ Incurred to date (a)	TP Estimate @ Month 1	REF
	A		B	C = A * B	
License Royalty	2% of Gross Rooms Revenues	\$0	\$8,000,000	\$160,000	(b)
Base	3% of Total Revenues	\$0	\$10,000,000	\$300,000	(a, c)
Incentive	8% of GOP (a minimum GOP threshold of \$10 million (prorated))	\$0	\$2,000,000	\$160,000	(c, d)
Employee payroll and benefits	Reimbursement of Costs incurred	\$0	\$50,000	\$50,000	(a)
Total		\$0	\$20,050,000	\$670,000	
<p>(a) The fees the Manager is entitled to under the agreement are driven by the underlying hotel activity (for example, the base fee is 3% of the total hotel revenues). Therefore, for the purposes of the example and clearly showing how the transaction price is calculated, the Manager is estimating the transaction price by identifying the actual hotel activity to applying the fee per the contract terms to that hotel activity, and then applying the constraint on incentive fees discussed in (d).</p> <p>(b) ASC 606-10-55-65 regarding sales-based and usage-based royalties promised in exchange for a license of intellectual property would be applied.</p> <p>(c) The Manager will not include an estimate of the future variable fees that will be earned under the remaining contract as these amounts will neither be recognized nor disclosed.</p> <p>(d) Based on the hotel's performance in Month 1, the amount earned per the contract terms was \$160k as the pro-rated hurdle for the month ($\\$10M/12 = \\$833k$) was met. The Manager reviewed the hotel forecast and has concluded it was probable that this amount would not reverse in subsequent periods and therefore the Manager has included \$160k in its estimate of the transaction price. While the Manager uses a forecast of the incentive fee to assess the probability that the transaction price earned to date will not reverse, the Manager has not included the forecasted incentive fee attributable to future periods in the estimate of the transaction price as this amount will neither be recognized nor disclosed. (As discussed in paragraph 32 above, in other situations the Manager may not be able conclude that the transaction price is probable to not reverse in subsequent periods and as such would not include the incentive fee in the estimate of the transaction price until that fee is more likely to be retained. Judgment will be required.)</p>					

Step 4: Allocating the transaction price

Allocation Objective

39. FASB ASC 606-10-32-28 states that, the objective when allocating the transaction price is for an entity to allocate the transaction price to each performance obligation (or distinct good or service in a series) in an amount that depicts the amount of consideration to which the entity expects to be entitled in exchange for transferring the promised goods or services to the customer.

Allocation of the Variable Fees within the Agreement to the Separate Performance Obligations and/or to the Distinct Good(s) or Services that Form Part of a Single Performance Obligation

40. In consideration of the allocation objective, FASB ASC 606-10-32-40 states that an entity shall allocate a variable amount entirely to a single performance obligation or to a distinct good or service that forms a part of a single performance obligation if both of the following criteria are met:

- a. The terms of the variable payment relate specifically to the entity's efforts to satisfy the performance obligation or transfer the distinct good or service (or to a specific outcome from satisfying the performance obligation or transferring the distinct good or service); and

- b. Allocating the variable amount of consideration entirely to the performance obligation or the distinct good or service is consistent with the allocation objective, when considering all the performance obligations and payment terms in the contract.
41. The structure of the management agreement typically separates the fees so that the compensation aligns with the related service being provided. For example, the license royalty and the base and incentive fees are typically related to a specific outcome from satisfying the hotel system IP and hotel management services performance obligations, respectively. Therefore, each of the variable fees charged within the management agreement may be linked to both a single performance obligation and/or a distinct service within the series (if applicable), as described in FASB ASC 606-10-32-40.
42. When allocating the variable fee streams to the separate performance obligations, the Manager should consider whether the fee specifically relates to the entity's efforts to satisfy its promises under the contract and/or the outcome of providing the distinct service (or bundle of services). Consistent with Example 12A, FASB ASC 606-10-55-157E, FinREC believes that as the terms of the variable consideration relate specifically to the Manager's efforts to transfer each distinct daily service, the allocation of the monthly base and incentive fee (or change in the incentive fee) to the daily services provided during the month they are billable (subject to the constraint) would meet the allocation objective. Similarly as the cost reimbursements are commensurate with the entity's efforts to fulfill the promise(s) each day, then the allocation objective would be met by allocating the fees to the daily services performed as the Manager incurs the associated costs.
43. FASB/IASB TRG Agenda Ref 39: *Application of the Series Provision and Allocation of Variable Consideration*, Example C, discusses a hotel manager that has entered into a 20 year agreement to manage properties on the behalf of the customer. Specifically, in paragraph 46 of TRG Agenda Ref 39, it is noted that the staff thinks the base monthly fees could meet the allocation objective for each month because there is a consistent measure throughout the contract period that reflects the value to the customer each month (the % of monthly sales). Similarly, if the cost reimbursements are commensurate with the entity's efforts to fulfill the promise each day, then the allocation objective for those variable fees could also be met. The paper noted that the allocation objective could also be met for the incentive fee if it reflects the value delivered to the customer for the annual period (reflected by the profits earned) and is reasonable compared to the incentive fees that could be earned in other periods.

Allocation of Discounts among the Performance Obligations

44. On occasion, the Manager may discount the standard hotel system IP fee and/or another fee in the agreement in order to incentivize the Owner to enter into the management agreement. FASB ASC 606-10-32-37 describes how an entity (the Manager) should allocate the discount entirely to one or more, but not all, performance obligations if all of the following criteria are met:
 - a. The Manager regularly sells each distinct good or service (or each bundle of distinct goods or services) in the contract on a standalone basis.
 - b. The Manager also regularly sells on a standalone basis a bundle (or bundles) of some of those distinct goods or services at a discount to the standalone selling prices of the goods or services in each bundle.
 - c. The discount attributable to each bundle of goods or services described in (b) is substantially the same as the discount in the contract, and an analysis of the goods or services in each bundle provides observable evidence of the performance obligation (or performance obligations) to which the entire discount in the contract belongs.
45. In the case of a management agreement where the Manager accounts for the hotel system IP and hotel management services as separate performance obligations and one or more of the fees is discounted from the standalone selling price, the Manager should consider whether it meets the criteria in FASB ASC 606-10-32-37 to allocate the discount entirely to one or more performance obligations. If it determines it does not, the Manager should consider whether any portion of the fees typically allocated to one performance obligation would be allocated to another obligation(s).

Allocation of Fixed Fees

46. Once the variable consideration has been linked to specific performance obligations, the Manager should evaluate any fixed fees to determine the appropriate allocation of these fees to the separate performance obligations in accordance with FASB ASC 606-10-32-28 through 32-38. In accordance with FASB ASC 606-10-32-29, the allocation should be performed based on the relative standalone selling price of the associated services within the contract. FASB ASC 606-10-32-32 explains that the best evidence of a standalone selling price is the

observable price of a good or service when the entity sells that good or service separately in a similar circumstance to similar customers.

47. Example Scenario - The following example is meant to be illustrative, and the actual determination of the application of ASC 606 should be based on the facts and circumstances of an entity's specific situation. The following example fact pattern is the same used throughout this document.

Contract Inception & Hotel Opening (January 1, 20X0 and January 1, 20X2)

In this example, at contract inception, the Manager considers the allocation of each of the variable fee streams to the hotel system IP license and the hotel management performance obligations. Each of the variable fee streams are "at-market" with similar arrangements entered into by the Manager. The license fee is representative of the fee charged under a standalone franchise arrangement, and the base, incentive, and employee payroll and benefits charges are representative of fees charged in standalone unbranded management agreement. Therefore if the Manager concludes that the variable fee streams will be allocated to either the hotel system IP license or the hotel management performance obligations based on which promises make up the respective performance obligation, the following table provides an example of how the allocation of the fees to the separate performance obligations at both contract inception & hotel opening would be reflected:

Fee	Calculation	TP Estimate @ Month 1 <i>See Above</i>
License Royalty	2% of Gross Rooms Revenues	\$0
Total Hotel System IP		\$0
Base	3% of Total Revenues	\$0
Incentive	8% of GOP (a minimum GOP threshold of \$10 million (prorated))	\$0
Employee payroll and benefits	Reimbursement of costs incurred	\$0
Total Hotel Management		\$0
Total		\$0

Month 1

In Month 1, the Manager allocates the change in the estimate for the transaction price related to the license, base, incentive, and employee payroll and benefits to the distinct services provided during the period as this meets the allocation objective as the change reflects the value of the services provided to the Owner and the entity's efforts to fulfill the promise.

Based on the analysis performed above, the Manager allocates the transaction price in Month 1 as follows:

Fee	Calculation A	TP Estimate @ Month 1 See Above	Allocated to		REF
			Current Period & Prior Services	Future Services	
License Royalty	2% of Gross Rooms Revenues	160,000	160,000	0	(a)
Total Hotel System IP		160,000	160,000	0	
Base	3% of Total Revenues	300,000	300,000	0	(a)
Incentive	8% of GOP (a minimum GOP threshold of \$10 million (prorated))	160,000	160,000	0	(a)
Employee payroll and benefits	Reimbursement of Costs incurred	50,000	50,000	0	(a)
Total Hotel Management		510,000	510,000	0	(a)
Total		670,000	670,000	0	
(a) The total estimate of transaction price relates to the distinct services provided during the period and is allocated to those services.					

Step 5: Recognizing Revenues when (or as) the Manager Satisfies the Performance Obligation

License Royalty Fees

48. Refer to Issue #7-1: *Franchise Fees*, for discussion regarding the recognition of the revenues related to the hotel system IP license.

Management Fees (Including Cost Reimbursements)

49. As concluded in paragraph 19, the series of hotel management services are a series of distinct services performed over time. Therefore, the manager would typically recognize the revenues related to the management fees (including cost reimbursements) when both of the following factors exist:

- The fee has been included in the estimate of the transaction price; and
- The distinct services to which the transaction price has been allocated have been provided.

Pre-opening Services and Other “Ad-Hoc” Performance Obligations

50. The Manager should evaluate the remaining “ad-hoc” services in the contract (if applicable) to determine the appropriate revenue recognition for these services. Considerations might include:

- Does control transfer at a point in time or over time as noted in FASB ASC 606-10-25-27?
- If the control transfers over time, what is the appropriate measure of progress towards completion as noted in FASB ASC 606-10-25-31 through 25-37, and 606-10-55-16 through 55-21?

Accounts Receivable and Contract Assets

51. If the Manager has an unconditional right to collect the consideration under the contract terms (consideration is billable per the contract terms), in accordance with FASB ASC 606-10-45-1 the amount should be presented separately as an account receivable.

52. If the Manager has performed by providing the distinct services to which it has allocated a portion of the estimate of the transaction price before the associated amount has been paid or an account receivable has been recognized (see discussion above), in accordance with FASB ASC 606-10-45-3 the Manager should present the associated transaction price as a contract asset. An example of where this may occur is when the Manager has recognized a portion of the incentive fee but does not have an unconditional right to payment for this amount until

an Owner's minimum return threshold is met for the annual incentive fee period. FinREC believes that the contract asset would be recognized ahead of the Manager having an enforceable right to payment at that specific point in time, if the Manager has concluded it is not probable the associated revenues will reverse as previously described in Step 3.

53. Example - The following example is meant to be illustrative, and the actual determination of the application of ASC 606 should be based on the facts and circumstances of an entity's specific situation. The following example fact pattern is the same used throughout this document.

Contract Inception to Hotel Opening (January 1, 20X0 and January 1, 20X2)

In the example, an estimate of variable fees (including license fees) have neither been included in the estimate of the transaction price nor allocated to the services that have been provided, and therefore the Manager did not recognize any revenues related to these fees upon hotel opening.

Month 1

As the performance obligation represents a series of distinct services, the Manager has decided to use time as its measure of progress and recognizes the revenues allocated to the distinct services provided to the Owner through the end of the period. At the end of Month 1, the Manager recognizes the revenue related to the amounts included in the transaction price and allocated to the current period services provided in Month 1 by recording the following journal entry:

Debit	Credit	Debit	Credit
Accounts Receivable		\$510,000	
Contract Asset		\$160,000	
Employee payroll expense		\$50,000	
	Royalty Fee		\$160,000
	Base Fee		\$300,000
	Incentive Fee		\$160,000
	Employee Payroll Expense Reimbursement		\$50,000
	Accrued Payroll Liability		\$50,000

In the example, the Manager does not yet have an unconditional right to payment for the portion of the incentive fee that is being recognized, as the Owner's minimum return threshold has not yet been met for the annual incentive fee period. However, as the Manager has concluded that it is probable that a significant revenue reversal will not occur (as previously described in paragraph 38, footnote (d) under Month 1), as such it is appropriate to include the variable fee in the transaction price, and therefore a contract asset would be recognized.

Comments should be received by June 1, 2017, and sent by electronic mail to Kim Kushmerick at kim.kushmerick@aicpa-cima.com, or you can send them by mail to Kim Kushmerick, Accounting Standards, AICPA, 1211 Avenue of the Americas, NY 10036.