

Financial Reporting Center – Revenue Recognition

Working Draft: Hospitality Revenue Recognition Implementation Issue



Issue #7-5 - Consideration to Customer (Key Money)

**Expected Overall Level of Impact to Industry Accounting:
Significant**

Wording to be Included in the Revenue Recognition Guide:

Background

1. Hospitality entities may make cash payments to customers (e.g., hotel owners) in connection with obtaining a franchise and/or management agreement. In some cases, hospitality entities may provide to the hotel owner other financing aids such as below-market financing or guarantees of other third-party financing¹. These payments or incentives are commonly referred to in the hospitality industry as “key money” payments.
2. Key money payments are generally used by hotel owners to finance new hotel developments or major property renovations. Key money payments are generally refundable to the franchisor/manager if the franchise and/or management contract is terminated. Franchise and/or management contracts are not generally terminable upon a sale of the hotel property to a new owner. When the hotel property is sold, the existing franchise and/or management contract is generally assigned to the new owner.
3. Payments of key money are not viewed by hospitality entities or hotel owners as a means to fund the future payment of franchise or management fees by the hotel owner. Hospitality entities are generally seeking to ensure the adequate capitalization of the hotel owner’s project, long-term operational viability of the hotel property and a means to meet and maintain brand standards, or if necessary, the completion of Property Improvement Plans (PIPs).
4. FASB ASC 606-10-25-9 states,

¹ The accounting for items such as guarantees and loans is subject to specific accounting guidance, if that specific guidance does not address accounting for the benefit received by the customer, FinREC believes the guidance in this paper should be considered for the benefit provided to a customer.

An entity shall 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 contracts as a single contract if one or 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 of 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 in accordance with paragraphs FASB ASC 606-10-25-14 through 25-22.

Determining Whether Key Money Payments are Consideration Payable to a Customer in the Scope of FASB ASC 606

5. FASB ASC 606-10-32-25 in part states,

Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer).

FinREC believes that the key money payments are consideration payable to a customer as the payments consist of cash or other incentive payments that are made directly to a customer.

Determining Whether the Key Money Payments are a Reduction of Revenue

6. FASB ASC 606-10-32-25 states, "[a]n entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity." FASB ASC 606-10-32-26 states, "[i]f consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity shall account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers."
7. Therefore, based on the guidance in paragraphs 25 – 26 of FASB ASC 606-10-32, hospitality entities that provide key money payments to hotel owners (including below market financing or guarantees of third-party financing) should evaluate whether these payments (or incentives) are provided in exchange for a distinct good or service from the hotel owner.
8. Hospitality entities may receive intangible or indirect benefits (other than franchise and/or management fees) from providing key money payments and obtaining a contract with a hotel owner. For example, key money payments may be used by the hotel owner to enhance the guest experience, thus increasing the likelihood that the guest will select another of the hospitality entity's branded properties in the future. Further, the addition of branded properties in key geographies or specific locations may enhance the brand's status and make loyalty program participation more desirable to potential customers.
9. While these intangible or indirect benefits provide value to the hospitality entity, FinREC believes they generally will not meet the criteria in paragraphs 18 – 22 of FASB ASC 606-10-25 to be distinct goods or services. The hotel owner generally is not performing a service, producing a good or granting any rights as contemplated by FASB ASC 606-10-25-18 that will be used by the hospitality entity in exchange for providing the key money payments. Further, any action performed by the hotel owner (e.g., using key money payments to complete the development of a new hotel property or to facilitate property improvements) generally would not meet the criteria in paragraphs 19 – 22 of FASB ASC 606-10-25 to be considered distinct from the other performance obligations in the contract. Therefore, FinREC believes that the key money payments will generally be recognized as a reduction in the transaction price and, therefore of revenue pursuant to FASB ASC 606-10-32-25.

Determining the Appropriate Amortization Pattern to Record the Key Money Payment as a Reduction of Revenue

10. FASB ASC 606-10-32-27 states:

Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

- a. The entity recognizes revenue for the transfer of the related goods or services to the customer.
- b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

11. Key money payments are generally made to the customer at or near the inception of a long-term management and/or franchise agreement. (e.g., ten year non-cancellable management/franchise agreement). Hospitality entities will generally capitalize key money payments and recognize a reduction of revenue from payments as the franchise rights or management services are transferred, subject to an assessment of the recoverability of the asset. Since the fees hospitality entities will receive for performing under the respective management and/or franchise contracts are generally subject to the allocation of variable consideration exception in paragraphs 39 – 41 of FASB ASC 606-10-32, or the sales-based or usage-based royalty exception in paragraphs 65 – 65B of FASB ASC 606-10-55, hospitality entities will not be required to estimate the fees they will receive for satisfying their performance obligations for measurement, recognition or disclosure purposes (see Issue 7-1: *Franchise Revenue Arrangements*, and 7-2: *Hotel Management Service Arrangements*, for conclusions related to the accounting for franchise and management agreements). Therefore, FinREC believes in a typical arrangement, hospitality entities should recognize the key money payments over the non-cancellable term of the contracts, unless another amortization period is more clearly discernable as discussed in the following paragraphs.

12. Hospitality entities may enter into contracts that permit the entity and/or the customer to terminate the contract prior to the end of the term of the contract. For example, a hospitality entity may enter into a management or franchise agreement with a customer that has a ten year term, cancellable by the customer at the end of each annual year, or that is cancellable by the entity at the end of year 5. In such instances, hospitality entities will need to assess whether the key money payment should be amortized over the ten year contractual term or a shorter period due to the termination clauses in the contract(s), or longer due to renewal features. In performing the assessment, hospitality entities should assess the whether the termination clauses impact the enforceable term of the contract (determining the enforceable term of the contract is not the subject of this paper). If the termination clauses do not impact the enforceable term of the contract, the key money payments should be amortized over the contractual term of the agreement, consistent with paragraph 11.

13. If the termination clauses impact the enforceable term of the agreement because, for example, a hospitality entity enters into a management or franchise agreement with a customer that has a twenty year term but the customer has a unilateral right to cancel the contract at the end of five years without incurring a substantive penalty (see Issue 2 of FASB IASB Transition Resource Group for Revenue Recognition (TRG) Agenda Ref 48: *Customer options for additional goods and services*), the hospitality entity should determine the appropriate period to amortize the payments. The TRG addressed similar issues in TRG Agenda Ref 59: *Payments to Customers*. TRG Agenda Ref 59 specifically addressed the following two scenarios:

- a. An entity makes an upfront payment to a customer (or a potential customer) and does not have a revenue contract (that is, there is not yet a contract to be accounted for under Topic 606). An entity might make an upfront payment in anticipation of future purchases from the customer.
- b. An entity makes an upfront payment to a customer and there is a revenue contract. However, the upfront payment relates to the current contract as well as anticipated future revenue contracts.

14. The TRG evaluated two views about the timing of when the reduction in revenue for an upfront payment should be recorded, as described in paragraph 24 of TRG Agenda Ref 60: *November 2016 Meeting – Summary of Issues Discussed and Next Steps*:

View A: Payments to customers should be recognized as a reduction of revenue as the related goods or services (that is, the expected total purchases resulting from the upfront payment) are transferred to the customer. The payment might be recorded in the income statement over a period that is longer than the current legally enforceable contract. Identification of the related goods or services will require judgment on the basis of the facts and circumstances. The asset would be periodically assessed for recoverability.

View B: Payments to customers should be recognized as a reduction of revenue from the existing contract (that is, existing enforceable rights and obligations). If no revenue contract exists, then the entire payment would be immediately recognized in the income statement.

15. TRG Agenda Ref 60, paragraph 25, summarizes the consensus reached by the TRG on this issue, as follows:

TRG members observed that View A would be appropriate in many cases. TRG members agreed with the staff view that if an asset is recorded it should meet the definition of an asset in FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements, and an entity should assess whether the asset is impaired in subsequent reporting periods. However, TRG members agreed with the staff view that View B could be appropriate in some cases. TRG members agreed with the staff view that the accounting is not a policy election and agreed that an entity should understand the reasons for the payment, the rights and obligations resulting from the payment (if any), the nature of the promise(s) in the contract (if any), and other relevant facts and circumstances for each arrangement when determining the appropriate accounting. TRG members also agreed with the staff that the assessment will require significant judgment in some cases and appropriate disclosures in the financial statements might be important.

16. In determining whether the key money payment should be recognized over the contractual term, or a shorter period, when the contract includes termination clauses that impact the enforceable term of the contract, hospitality entities should assess the period of benefit for the asset, which would include an assessment of the likelihood the contract will be terminated before the end of the contractual term. The objective is to determine the period of benefit for the asset, including an assessment as to whether the asset is impaired. In making this assessment, hospitality entities should consider the following:

- a. The reason the termination provisions have been included in the contracts.
- b. The entity's history with similar termination provisions made to similar classes of customers.

17. As noted in paragraph 2, management and franchise contracts generally cannot be terminated in the event the hotel(s) related to such contracts are sold to a new owner. In the event that a hotel is sold that is encumbered by a management and/or franchise contract, hospitality entities should re-assess the recoverability of the key money asset capitalized at the sale date as the counterparty that will be obligated to pay the fees under the contracts (which are the cash flows that are used to assess recoverability) has changed. However, FinREC does not believe that a change in owner would require an immediate write-off of the key money payment as the hospitality entity will continue to generate cash flows to assess the recoverability of the asset. Additionally, in instances where a management contract is modified to a franchise contract, or vice versa, judgment will be required to re-assess if this represents a contract modification under paragraphs 10 – 13 of FASB ASC 606-10-25.

Comments should be received by August 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.

DISCLAIMER: This publication has not been approved, disapproved or otherwise acted upon by any senior committees of, and does not represent an official position of, the American Institute of Certified Public Accountants. It is distributed with the understanding that the contributing authors and editors, and the publisher, are not rendering legal, accounting, or other professional services in this publication. If legal advice or other expert assistance is required, the services of a competent professional should be sought. Copyright © 2016 by American Institute of Certified Public Accountants, Inc. New York, NY 10036-8775. All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please email copyright@aicpa.org with your request. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, 220 Leigh Farm Road, Durham, NC 27707-8110.