Changes in financial reporting: the new revenue recognition standard

The way that hospitality companies recognize revenue will soon change after the long-awaited revenue recognition standard is issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards).[69] The standard will supersede nearly all revenue recognition guidance in US generally accepted accounting principles (GAAP) and IFRS; as a result, hospitality companies around the globe will need to re-evaluate their policies and practices for recognizing revenue for arrangements associated with owned, managed and franchised properties.

The standard uses a five-step model to outline the principles an entity must apply to measure and recognize revenue and related cash flows from contracts with customers. The model's core principle is that an entity will recognize revenue at an amount that reflects the consideration to which it expects to be entitled in exchange for transferring goods or services to a customer.

When applying this model, hospitality companies must use greater judgment and make more estimates than they currently do under today's guidance. Areas needing increased judgment may include identifying the performance obligations (i.e., promises to transfer distinct goods or services to a customer) in the contract, making estimates of the amount of variable consideration to include in the transaction price and determining how the transaction price should be allocated to each performance obligation.

For example, a hotel management company offers services to hoteliers governed by the stipulations of a hotel management contract. Under the new revenue recognition rule, the management agreement must be analyzed to determine if the stipulations represent performance obligations. Specific contractual obligations may include arranging services for hotel guests, employing hotel personnel, providing revenue management and accounting services, granting the right to use intellectual property and trademarks and performing marketing activities. Substantial judgment will be necessary to determine which of these stipulations individually, or when bundled with other promises in the arrangement, represent performance obligations.

After performance obligations are identified in an arrangement, the transaction price is determined. The transaction price includes an entity's estimates of variable consideration that it may be entitled to from the arrangement when it is probable[70] that a significant reversal of revenue will not occur in a future period. The standard refers to this threshold as a "constraint." This differs from current guidance, which allows for revenue recognition only when amounts are fixed and determinable. Variable consideration may include amounts that are earned based on the underlying performance of the property (e.g., a percentage of hotel revenues) or incentives that are earned when certain performance thresholds are met.

69. The FASB issued the new revenue standard in Accounting Standards Update 2014-09, *Revenue from Contracts with Customers*. The guidance will be codified in Accounting Standards Codification 606, *Contracts with Customers*. The IASB issued the new revenue standard in IFRS 15, *Contracts with Customers.*

70. The IASB standard uses "highly probable," which has the same meaning as "probable" in US GAAP.

Once the performance obligations are identified and the transaction price is determined, companies must allocate the transaction price to each performance obligation. The standard generally requires that entities allocate the transaction price to the performance obligations in proportion to their stand-alone selling prices. However, in certain circumstances, variable consideration may be allocated to a distinct service in a series of distinct services (e.g., the management services performed in the second month of a one-year contract). Revenue for each performance obligation is then recognized when the performance obligation has been satisfied, which is when the good or service has been transferred to the customer.

The new revenue recognition standard also provides specific guidance for recognizing revenue from sales-based royalties earned in exchange for granting distinct licenses of intellectual property (e.g., use of brand names and trademarks) that differs from the general model described above. Under this specific guidance, royalties from such arrangements are not recognized as revenue before the subsequent sales occur. As a result, hospitality companies would not be required to include in the transaction price amounts expected to be received in exchange for distinct licenses of intellectual property until the subsequent sales occur.

The accounting for gains and losses on the sale of certain nonfinancial assets, including real estate properties, also may change in certain circumstances. Under the new standard, when real estate is sold and a management or franchise agreement is retained, it is more likely that the transaction will qualify for sale recognition, and that revenue (i.e., gain on sale) will be recognized sooner than it is under today's accounting. In comparison, under current guidance,[71] the restrictive recognition criteria that must be applied to real estate sale transactions often delays the recognition of a sale and/or results in a deferral of the associated gain on sale.

Other considerations that hospitality entities will need to evaluate include how to recognize amounts paid to real estate owners to secure management or franchise contracts, whether reimbursements received for payroll and other costs incurred should be presented on a gross or net basis, and the accounting for customer loyalty points programs.

Most public entities will adopt the standard in 2017, while most private entities will adopt it the following year. Early adoption is allowed under IFRS; however, public companies that report under US GAAP are not permitted to early adopt, while nonpublic companies applying US GAAP may elect to adopt the standard at the same time as public companies.

The standard allows for either "full retrospective" adoption, meaning it is applied to all periods presented in the financial statements, or "modified retrospective" adoption, meaning it is applied only to the most current period presented in the financial statements, but other disclosures are required.

71. Accounting Standards Codification 360-20, *Real Estate Sales*.

With over two years until the effective date, it may appear that there is ample time to prepare for adoption of the new guidance. But companies should begin working with auditors and other advisors to evaluate their existing revenue arrangements and address interpretation and application issues. While some companies may be able to implement the standard with limited effort, many companies will find implementation to be a significant undertaking. Companies with more work in front of them will need to move at a faster pace and may need to consider adding resources. An early assessment is vital to managing implementation.

Early communication with key stakeholders (e.g., audit committees, investors) will be important if a company anticipates significant changes in the timing and presentation of revenues. In addition, consideration should be given to whether any changes are needed in internal control over financial reporting.

In addition to their internal preparations, hospitality companies should monitor the discussions of the hospitality industry task force that was formed by the American Institute of Certified Public Accountants (AICPA) to discuss the standard's application to common industry transactions. They also may want to monitor the discussions of the Joint Transition Resource Group for Revenue Recognition (TRG) established by the Boards to help them determine whether additional guidance or clarification is needed.