# Financial Reporting

# A CLOSE LOOK AT THE USALI 11TH REVISED EDITION

# Part III: Gross vs. Net Reporting

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he *Uniform System of Ac*counts for the Lodging Industry (USALI), 11th Revised Edition is the resource's most current edition, which was effective as of January 1, 2015. In conjunction with its release, The Bottomline has published a threepart series that offered details into the changes to this latest edition. In the first two articles printed consecutively in the previous issues, the articles covered: an overview of the changes and financial ratios and operating metrics. This article, the final article in the series, focuses on gross versus net reporting.

The newest section of the *USALI* 11<sup>th</sup> Revised Edition has generated a number of spirited and insightful discussions. It is not just because it is new, but it has to do with how revenues should be reported as gross or net. Included in this section are also guidelines as to how surcharges, service charges and gratuities need to be recorded. This section is an effort to further align the *USALI* with *GAAP*, and also eventually the *IFRS*.

# **Implications on Profits**

On the surface, the recording of revenue on a net or gross basis may not appear to have an impact on the



net operating income of a hotel. Either the hotel earned \$1,000 in net income, or it achieved \$1,500 in revenue and spent \$500 in direct costs. Either way, \$1,000 dollars drops to the bottom line.

There are several expenses, however, that a hotel pays that are usually charged as a percent of some form of revenue. Examples of such expenses include base management fees, franchise fees, employee bonuses and credit card commissions. Frequently the contracts that dictate how the fee, bonus or commission is calculated refer to the *USALI* to define the applicable revenue. This further underscores the need to have a thorough understanding of the *USALI* and how it defines revenue.

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# **Net vs. Gross**

# Indicators from the USALI that define revenue as gross or net

#### Net — Three Indicators

- The supplier is the primary obligor
- The hotel earns a fixed amount on the transaction regardless of the actual amount billed to the customer
- The supplier, not the hotel, carries the credit and collection risk

## **Gross** — **Eight Indicators**

- The hotel is the primary obligor
- · The hotel, carries the credit and collection risk
- The hotel has a list of suppliers and decides on the supplier to fulfill that product or service
- The hotel has control in determining the nature, type characteristics or specifications of that product
- The hotel has reasonable latitude to establish the price for the service or product
- The hotel adds meaningful value to the product or provides a significant portion of the service
- The hotel has to carry an inventory and the customer has a right to return
- The hotel has to absorb the risk of a physical inventory loss

Management fees is an obvious example of how the gross versus net recording of a revenue can impact how much profit will end up in the pocket of an owner or the management company. As presented later in this article, a controller may have to decide whether to record parking revenue on a gross or net basis. If a hotel earns \$500,000 in parking revenue on a gross basis, and pays their management company a base management fee equal to four percent of total operating revenue, then the full \$500,000 in parking revenue rolls up into the hotel's total operating revenue and results in \$20,000 in management fee expense. On the other hand, if facts and circumstances dictate that the hotel needs to only record \$300,000 of parking revenue on a net basis, then only \$300,000 goes towards total operating revenue, and the management fee expense is reduced by \$8,000. That means \$8,000 more in proceeds for the owner, but \$8,000 less for the operator.

While the decision to record revenue on a net or gross basis may not have a direct impact on net operating income, the potential effect on revenue-related expenses does mean that the net versus gross decision indirectly impacts profits.

Even more interesting is not what is net versus gross, but how revenues are to be considered as net or gross. In theory, it can be as simple as whether the said property is acting in the role of the principal or an agent. If the hotel is the principal in the transaction, then the revenue should be recorded as gross, under a separate Other Operated Department. Conversely, if the hotel is simply acting as an agent, then the revenue should be recorded as net, as a source of Miscellaneous Income. There are indicators to assist individuals to make the decision. However, the presence of the indicators alone also does not point directly to a yes or no; rather, it is the relative strength of

each of the indicators in totality that determines the outcome. As such, the *USALI* stresses that these indicators should not be considered "presumptive" or "determinative." Therefore, this article will first address the indicators or criteria of gross versus net reporting. Then examples of gross versus net reporting will be shared. Finally, a discussion of whether funds should be recorded as surcharges, service charges or gratuities will be presented, with scenarios included for illustration.

## What is Net?

The *USALI* offers three indicators to test if the revenue earned is considered NET. First, the supplier is the primary obligor. In other words, the hotel is NOT. The hotel is not the responsible party for the fulfillment of the service or product, and normally in the marketing materials and/or sales contract, this responsibility is clearly indicated. Second, the hotel earns a fixed amount on the transaction regardless of the actual amount billed to the customer. The agreement may be a fixed dollar amount or a fixed percentage — but the key is that the amount is fixed. Third, the supplier, not the hotel, carries the credit and collection risk. It is also important to note that even if a hotel acts as an agent for the customer and the supplier (as a go-between, more for the convenience of all parties) in the collection process, it does not mean the hotel bears the credit or collection risks. All these indicators demonstrate the fact that the hotel is an agent, not the principal, and thus revenues earned in products and services under these circumstances should be recorded as net, under Miscellaneous Income.

#### What is Gross?

For revenues to be considered as GROSS, the *USALI* offers eight different litmus tests. The first indicator is simple: the hotel is the primary obligor. The hotel is responsible to provide the products and services. However, the simplicity stops here. What if the



hotel supplies the products and services, but if something is wrong and needed to be rectified, it falls under the responsibility of the supplier? In this case, this indicator is in the gray area as the hotel's risk as the primary obligor is partially diminished. Thus, as mentioned before, all indicators need to be evaluated in totality to come to the proper conclusion.

The second indicator is identical to the third indicator as discussed for net reporting. In other words, if the hotel assumes the credit/collection risk, the revenues are to be recorded as gross. And, also similar to the facts discussed earlier, the credit/collection risk of the hotel is said to be negated under certain circumstances such as when a hotel only returns or refunds the net amount earned in the transaction if the transaction is cancelled. Third, if the hotel has a list of suppliers to fulfill that product or service, and the hotel holds the decision at the time of the transaction to select the supplier, then the hotel is primarily responsible for the fulfillment and thus the revenue again should be recorded as gross.

The next three indicators have to do with the amount of control the hotel has. If a hotel has control in determining the nature, type, characteristics or specifications of the service or product, or the hotel has reasonable latitude to establish the price for the service or product, or the hotel adds meaningful value to the product or provides a significant portion of the service, then the indicator would dictate the revenue to be recorded as gross.

The last two indicators for gross revenue reporting have to do with the inventory of the product or service. If a hotel has to carry an inventory and the customer has a right to return, then the indicator is positive. Similarly, if the hotel has to absorb the risk of a physical inventory loss, the indicator is also positive.

So, now with three indicators of net revenue reporting and eight indicators of gross revenue reporting, let us look at four scenarios. Many hotels offer valet parking. However, some are run by the hotel, some are with a contracted service, some are with a concessionaire, and contracts can be written with varied clauses. The four scenarios are all about one service: parking. And yet, the revenue reporting can be very different.

#### Scenario One

Hotel Alpha owns the parking lot, hires and trains all the parking attendants, sets the prices for various lengths of parking, performs all the services for the guests, collects the revenues and absorbs all costs pertaining to the operation of this valet service. In this scenario:

- Hotel Alpha is the primary obligor (indicator 1 for gross reporting)
- Hotel Alpha has credit/collection risk (indicator 2 for gross reporting)
- Hotel Alpha has control over the nature and type of services (indicator 4 of gross reporting)
- Hotel Alpha has control over the establishment of the price (indicator 5 of gross reporting)
- Hotel Alpha provides a significant portion of the service, they actually hire and train all parking employees (indicator 6 of gross reporting)

Incidentally, Hotel Alpha absorbs all the costs associated with the operations

**FINDING:** Categorically Gross Revenue Reporting. Hotel Alpha has total control and absorbs any risks and loss.

# **Scenario Two**

Hotel Beta uses an outside contractor, Paramount Parking, to provide valet parking services to its guests. Paramount Parking operates under the rules set forth by Hotel Beta as the employees are hired and trained by Hotel Beta. In return, Paramount Parking charges Hotel Beta a fixed percentage of revenue as its monthly fee. Hotel Beta does all the credit and collection as their property management system feeds all the data directly to the guests' folios. In this scenario:

 Hotel Beta is the primary obligor (indicator 1 for gross reporting)

- Hotel Beta has credit/collection risk (indicator 2 for gross reporting)
- Hotel Beta has control over the nature and type of services (indicator 4 of gross reporting)
- Hotel Beta has control over the establishment of the price (indicator 5 of gross reporting)
- Hotel Beta provides a significant portion of the service, they actually hire and train all parking employees (indicator 6 of gross reporting)
- Paramount Parking receives a fixed percentage (indicator 2 of net reporting — in the case for Paramount)

FINDING: Still Gross Revenue Reporting. The fact that Paramount is the contractor does not negate the fact that Hotel Beta still has the majority control.

### **Scenario Three**

Hotel Charlie is a downtown hotel and it also owns a multi-story parking garage next door. However, instead of operating its own valet and parking service, Hotel Charlie has a list of supplier options, selects Profit Parking as its contractor, and leases the garage to Profit Parking. Profit Parking sets the price levels and hires the employees. To have a seamless appearance, Profit Parking outfits its employees with similar uniforms as those worn by employees of Hotel Charlie. As it is a lease, Hotel Charlie is not responsible for any vehicle losses or damages, nor is it responsible for any unpaid parking fees. Guests, however, can pay Profit Parking as they exit or they can also charge the parking fees to their rooms, though they are not told explicitly that Profit Parking and Hotel Charlie are different entities. If guests do choose to charge their parking fees, Hotel Charlie will remit the collected amount back to Profit Parking on a periodic basis. In this scenario:

 Hotel Charlie has a list of supplier options and selects Profit Parking (indicator 3 of gross reporting)

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# **For Further Review**

More details on the 11th revised edition

## HFTP Guide to the USALI 11th Revised Edition

HFTP has put together an online guide to the 11th Revised Edition, including the articles that have been published in *The Bottomline*, a survey report on usage (preview on page 34), and additional articles. Find it in the Education and Resources section of the HFTP web site at www.hftp.org.

## Access the 11th Edition

The *USALI* 11th edition is available for purchase at **www.ahlei.org**. To get the HFTP member discount, enter promo code HFTPC.

In addition, as an HFTP member, you have the access to the **Global Hospitality Accounting Common Practices** (GHACP) database where you can access the *USALI* 11th revised edition and compare it to the 10th revised edition and other common practices in other regions of the world (access at www.ghacp.org).

• Guests *may believe* Hotel Charlie is the service provider because of the similar uniforms of the parking attendants and hotel employees.

#### However.

- Profit Parking is the primary obligor (indicator 1 of net reporting)
- The amount of money Hotel Charlie earns is fixed (indicator 2 of net reporting)
- Credit/collection risk is that of Profit Parking (indicator 3 of net reporting)

FINDING: Preponderance for Net Revenue Reporting for Hotel Charlie. Profit Parking assumes more risk, including damages and losses to the vehicles. Thus, the income from the lease is to be recorded as net revenue under Miscellaneous Income

# **Scenario Four**

Hotel Delta is a downtown property and is located next to a multi-story parking garage owned by Perfect Parking. With the shortage of space to build a garage of its own and with an option right next door, Hotel Delta contracts with Perfect Parking to provide parking service for its guests. Hotel Delta does not set the rate. It simply collects the parking revenue and remits to Perfect Parking net of its set commission as agreed in the contract. Hotel Delta also does not add

a mark-up on the price set by Perfect Parking. Perfect Parking owns the garage, sets the price, hires and trains the employees. In this scenario:

- The supplier, Perfect Parking, is the primary obligor (indicator 1 for net reporting)
- The amount Hotel Delta earns is fixed (indicator 2 for net reporting)
- The credit/collection risk is with Perfect Parking (indicator 3 for net reporting). Although Hotel Delta is responsible for the collection, this does not mitigate the risk for Perfect Parking. In fact, Hotel Delta has neither risk nor rewards of operating the garage.

**FINDING**: Absolutely Net Revenue Reporting for Hotel Delta and the revenue should be recognized as Miscellaneous Income.

The 11th Edition of the USALI provides several other areas where gross versus net must be carefully considered. These areas include: laundry and dry cleaning, in-room entertainment, audio visual, retail outlets and recreational activities.

## The Mandatory/Discretionary Dyad

Revenue or not revenue? That is the million dollar question. What are considered surcharges? Are they the same or different from service charges? And should gratuities be recorded as

revenues for a hotel? The litmus test to these questions is the mandatorydiscretionary dyad. In other words, do guests have a choice?

Surcharges and service charges are quite different from gratuities. They are normally mandatory where guests do not have a choice, and are charged directly to a guest's folio. Other indicators are that the hotel is the primary obligor, sets the price, holds the credit/collection risks and also determines the specifications of the product or service. Examples of surcharges include resort fees, banquet service charge, room service delivery charge, pool towel charge or a corkage fee. The difference between surcharges and service charges is that all mandatory fees that are told to the guests as a service charge like that of room service are classified as service charges. Any other mandatory fees not stated as a service charge are considered a surcharge. Thus, resort fees will be a surcharge. All surcharges and service charges are to be recorded in the proper department as revenue or as miscellaneous income.

Gratuities, however, are at the discretion of the guests. A hotel may suggest guests to provide a certain percent of the bill as gratuity. So long as it is a suggestion and not automatically added to the bill where the guests have no choice, such are considered as tips and should not be considered as revenues. As it has always been, gratuities, or TIPS, are there "to insure prompt service." Gratuities therefore are never mandatory and are to be retained by the employees. They are not income of the hotel, even if the hotel collects them (audit/debit cards for example) and redistributes back to the employees at a later date.

## **Conclusion**

As time changes, accounting rules are updated, guidelines become more precise and accounting processes are more transparent. Change is good. We may need to adjust. But at the end, it is worth it.