

Duff on Hospitality Law

## **Owner Beware: Changes Coming for Recognizing Revenue under Online Travel Agency (OTA) Contracts**

on 10.24.17 | Posted in OTA

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Revenue is an important indicator of a hotel property's financial health. It is used to analyze and interpret financial results using key industry operating metrics ( i.e., average daily rate [ADR] and revenue per available room [RevPAR]).

Revenue may also drive the calculation of certain costs, such as management fees, franchise fees, capital improvement reserves, marketing fees and business taxes, as these are often calculated based on a percentage of revenue. As a result, owners and operators need to be aware of changes coming in financial reporting standards related to revenue recognition effective January 1, 2018 (public companies) and January 1, 2019 (private companies).

One change that may be particularly significant to the hotel industry relates to the recognition of revenue under online travel agency (OTA) contracts. Currently, revenue under OTA contracts is recognized under two different models, which are compared in the table below.

### **Commission Model**

#### **Merchant Model**

1. The guest makes his or her hotel room reservation using an OTA.
  2. Payment for the room is made by the guest at the hotel at the end of their stay.
  3. The hotel collects the payment and remits a commission to the OTA.
  4. The hotel recognizes the room revenue at the room rate collected and records an expense for the OTA commission.
  5. Revenue under this model is currently recognized on a "gross" basis.
1. The guest makes his or her hotel room reservation using an OTA.
  2. Payment for the room is made by the guest to the OTA upon booking.

3. At checkout, the OTA remits payment to the hotel for the net amount of cash received (i.e., total room rate less the OTA margin).
4. The hotel recognizes the room revenue at the net amount collected from the OTA.
5. Revenue under this model is currently recognized on a “net” basis.

Each model results in different financial reporting results. Revenue is lower when revenue is recognized on a “net” basis versus revenue recognized under a “gross” basis. Recall that this was the primary objection by hotel owners when Expedia introduced its Expedia Traveler Preference (i.e., commissionable model).

So, how does OTA revenue recognition change under the new standard?

#### **Who is in control?**

The new standard addresses the potential for inconsistent application of the revenue recognition standards when another party along with the hotel is involved in providing goods or services to a guest. The new standard requires a hotel to determine if it is the principal in the sales transaction, thereby requiring it to recognize revenue on a “gross” basis versus a “net” basis.

The principal in the transaction is the entity that controls the goods or services before they are transferred to the guest. To determine if an entity has control, ask:

- Who is primarily responsible for fulfilling the promise to provide the goods or service?
- Who bears inventory risk?
- Who has authority in establishing the price of the goods or service?

In both of the OTA models described above, the hotel controls the goods or services before they are provided to the guest, and the hotel is primarily responsible for fulfilling the promise to provide a room to the guest. The OTA does not bear the risk as the hotel does when the hotel room will not be sold, and the hotel primarily establishes the price of the room. These control indicators likely establish the hotel as the principal in the transaction and requires the hotel to recognize room revenue on a “gross” basis.

However, if the terms of the applicable OTA agreement state that the OTA has the right without the hotel’s approval to do any of the following:

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- Package the room with other goods or services (e.g., flight, rental car).
- Establish the price of the room.
- Commit to obtaining a certain number of rooms.
- Charge additional service fees to the guests.

Then, the revenue may continue to be recognized by the hotel on a “net” basis under the merchant model. These indicators, depending on circumstances, provide evidence that the OTA controls the good or service before providing it to the guest.

It should be noted that the “gross” versus “net” revenue recognition principle may also apply to other common hotel revenue sources – laundry, parking, audiovisual and recreational activities. In many instances, a third party is involved in providing these goods or services to the guests. Therefore, these agreements should also be reviewed to determine proper revenue recognition on a “gross” basis versus a “net” basis.

It is important that owners and operators proactively address the changes in the new revenue recognition standard by reviewing their OTA agreements. Do you understand the terms of your OTA agreements and the effect they may have on the recognition of revenue and expenses for your hotel? If not, now is the time to review your OTA agreements with your attorney and accountant so that you are not surprised by your hotel’s bottom line when the new revenue recognition standard takes effect.

**Tags:** financial reporting standards, hotel property, Online Travel Agencies, OTA agreements, OTAs, revenue recognition, revenue recognition standard, room revenue