

## HOW WILL THE 11<sup>TH</sup> EDITION OF THE UNIFORM SYSTEM AFFECT YOUR MANAGEMENT AGREEMENT?

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The AHLA issued the new 11<sup>th</sup> edition of the Uniform System of Accounts for the Lodging Industry (USALI) in July 2014. The process took almost three years and the edition reflects the first time that ownership interests were included in the Financial Management Committee that previously comprised only operators, industry consultants, CPAs and educators. While there are many changes from the 10<sup>th</sup> to 11<sup>th</sup> editions, this article addresses what owners and operators need to evaluate to understand the impact of the 11<sup>th</sup> edition on manager fees and performance tests.

### Recommendations for Evaluating Current Agreements.

The 11<sup>th</sup> edition includes title and definition changes as well as new schedules. For example Total Revenue is replaced with a new term called Operating Revenue. There is also a new schedule that is reported below GOP that includes revenue not generated by the operator (including interest income, other income such as antenna lease income and cost recovery income). You or your lawyer should determine how these changes affect base fees, incentive fees and performance tests. Please note that these changes are effective January 1, 2015.

Items to evaluate include:

### REVENUE TERMS

- How does the new definition of Operating Revenue compare to your agreement's definition of Total or Gross Revenue? *(Please note that Gross Revenue is not a GAAP or USALI term.)*
- Does the relocation of resort fees from rooms to miscellaneous revenue affect your hotel's RevPAR penetration? *Since all hotels must conform, the impact should be minimal unless only a portion of the competitive set charges a resort fee.*
- If your hotel includes a rental management program, how does the new reporting regarding short term versus long term revenue affect your RevPAR?
- Does the contract definition of Gross or Total Revenue include a catch all phrase such as "in accordance with the most current edition of the Uniform System" or "derived directly or indirectly by Operator"? If yes, then this terminology may support embracing the new 11<sup>th</sup> edition of Operating Revenue despite defined terms in the contract.
- If you are in the middle of a two year performance test, will the 10<sup>th</sup> edition apply for 2014 and the 11<sup>th</sup> edition for 2015?

## PROFIT TERMS

- How does the reallocation of certain income to Non-Operating Income (which is a new schedule below GOP) affect the GOP performance test calculation?
- How does the 11<sup>th</sup> edition's change in terminology from NOI to EBIDTA and new definition of Net Income affect any performance test or incentive fee calculations?
- If incentive fees are based on year-over-year GOP improvement, how will changes between 10<sup>th</sup> and 11<sup>th</sup> editions addressed for 2015 (versus 2014)?

Almost all management agreements agree to comply with USALI (from a reporting and/or terminology standpoint). How will our industry address the inconsistency of the defined terms in existing management contracts and an agreement's obligation to comply with the current USALI? That will be a major point of contention in our view.

The degree of impact will depend upon the drafting of the agreement as well as whether the agreement is subject to the current edition of USALI for compliance or a prior edition. If your agreement is subject to a prior edition, then financial statements must be presented in accordance to that edition. Almost all operators only present in the current edition so creating a bridge to reflect a prior edition will be a cumbersome, but worthwhile chore in order to ensure compliance and accuracy of fees paid.

### Thoughts for Future Agreements

If you are in the middle of negotiating a management agreement, we have the following additional recommendations:

- **Use terms that conform to USALI and ensure that these terms are based on the USALI definition.** The management agreement should address the exceptions to the definition, but not the defined term. Gross Revenue and Operating Profit are not USALI terms. Standardization of our industry's key terms reduces interpretation and enhances consistency for benchmarking.
- **Define Operating Revenue to exclude services charges, surcharges and cost recovery of expenses** as they are considered revenue per GAAP and are therefore included in the definition of Operating Revenue per USALI . Most hotel management agreements have a standard list of exclusions from revenue already commonly excluding service charges.
- **Be sure to understand the implications of defining revenue as either gross or net** and negotiate, in advance, what revenue will be defined as net rather than leaving interpretation to GAAP. Alternatively, ensure that the owner has the right to approve all contracts where revenue could be recorded as gross or net. The most common include parking and audiovisual agreements. Otherwise,

there could be a risk that the Operator will write these agreements to increase the collection risk to the hotel (and Owner) in order to report the revenue as Gross.

- Carefully define the definition of Hotel Premise (or what real estate is controlled by Operator). Carve out income opportunities on the roof, façade and in any other areas that an Owner may want to control or where hotel operators traditionally don't add value. Further, we recommend evaluating whether tri-party agreements (between the owner, Operator and tenant) influence whether the revenue is recorded as gross versus net.
- We recommend that all new management contracts be **subject to current (versus prior) USALI editions**; monitoring 2 editions is cumbersome and Operators don't keep two sets of accounts in order for Owner to accurately monitor compliance.

### Implications for Franchise Agreements

All franchise agreements charge fees against rooms revenue and many also charge fees on F&B revenue. The following should be reviewed in your franchise agreement relative to the 11<sup>th</sup> edition.

- New inclusions and exclusions of revenue in rooms and F&B revenue may affect the fee calculation.
- Clarification of the package revenue allocation may change the amount allocated to rooms revenue.
- Some franchise agreements require that breakfast packages be included in rooms revenue which is inconsistent with USALI.
- Moreover, package breakage is not rooms or F&B revenue. Operators must be sure to correctly allocate breakage to Miscellaneous revenue which is not subject to franchise fees.

### About hotelAVE

Hotel Asset Value Enhancement, Inc. ([www.hotelAVE.com](http://www.hotelAVE.com)) represents the nation's leading hospitality asset management firm, with a very successful 10+ year track record in asset management and prior institutional ownership. Featuring a management team consisting of former general managers, owners, and consultants, hAVE offers over 300 years of hotel real estate investment, operations and asset management. The organization's current asset management portfolio comprises over \$4B and 15,000 rooms and the firm advises on an additional \$4B annually including the following services: acquisition underwriting and due diligence, new manager and franchise selection, and development planning and repositioning services. hAVE

works closely with many owners and law firms to negotiate management agreements on behalf of owners. hAVE's offices are in Providence, New York and LA servicing clients in the Americas and Europe. . Michelle Russo is on the Financial Management Committee of the AHLA which authors the Uniform System of Accounts.

hotelAVE created an *11<sup>th</sup> Edition of USALI - Key Changes and P&L Implications* reference grid. Please view our website at [www.hotelAVE.com](http://www.hotelAVE.com) to download a complimentary copy. We also recommend that owners purchase a copy of the 11<sup>th</sup> edition of the Uniform System of Accounts thru [www.ahlei.org](http://www.ahlei.org).