

**HOTEL MANAGEMENT CONTRACTS AND DEFICIENCIES IN
OWNER-OPERATOR CAPITAL EXPENDITURE GOAL CONGRUENCY**

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Abstract

A review of the findings of prior empirical research concerning hotel management contracts between owners and operators is undertaken. It is noted that management contracts have become increasingly commonplace in the international hotel sector and that gross revenue and gross operating profit are the most extensively used determinants of operator incentive fee remuneration. These findings present a platform for examining how revenue and gross operating profit are deficient in promoting owner-operator goal congruency. In light of this, return on investment (ROI) and residual income (RI) are examined as potential alternative determinants of operator reimbursement. While it appears that both ROI and RI as determinants of hotel operator fees would represent an advance in promoting owner-operator goal congruency, a rationale outlining how residual income is preferable to ROI is outlined.

Keywords: Hotel management contract, return on investment, residual income, capital expenditure.

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INTRODUCTION

Collier and Gregory (1995a) feel that capital budgeting research is particularly warranted in hotels due to their dual role of property and guest management and because of their high proportion of capital intensive assets. Further, hotels are vibrant organisations characterised by complex buildings that are costly to maintain (Chan, Lee, & Burnett, 2001). The importance of these assets underscores the view that the most important budget in a hotel is the capital budget (Condon, Blaney, & Harrington, 1996; Lynch, 2002).

Guiding (2003, 2006) notes heightened capital budgeting complexity in hotels operating with a management contract, because the capital outlay decision must traverse organisational boundaries in satisfying investment criteria of both owner and operator. Given the high incidence of owner-operator hotel management contracts and the particular governance challenges arising, Field (1995) expresses surprise at the minimal academic research directed towards furthering our appreciation of this idiosyncratic governance arrangement.

While there is a large literature concerning capital budgeting practice in hotels (e.g. Brander-Brown, 1995; Collier & Gregory, 1995a, 1995b; Damitio & Schmidgall, 2002; DeFranco, 1997; Eder & Umbreit, 1987; Eyster & Geller, 1981; Field, 1995; Guiding, 2003, 2006; Guiding & Hargreaves, 2003; Guiding & Lamminmaki, 2007; T. Jones, 1998; Schmidgall & Damitio, 1990; Schmidgall & Ninemeier, 1987), few studies have investigated the particular capital budgeting issues arising in hotels governed by a management contract (Field, 1995;

Guiding, 2003, 2006). This is surprising as Beals and Denton (2005, p. 144) contend that expectations concerning operators' appropriate expenditure of owners' money have been severely undermined by field observations and law court judgements. This beckons a fundamental examination of this critical aspect of the owner-operator relationship.

These factors provide the contextual motivation for this study. The study's objective is twofold. Firstly, it seeks to provide an examination of management contract provisions pertaining to hotel operator remuneration and to explicate shortcomings of these provisions in promoting owner-operator capital expenditure goal congruency. Secondly, it examines the relative merits of alternative determinants of hotel operator fees, such as return on investment and residual income. The importance of remunerating a hotel operator in a manner consistent with promoting owner-operator capital expenditure goal congruence becomes particularly evident when we recognise that it is the hotel operator that generally initiates capital expenditure proposals (Guiding, 2006). Should capital expenditure goal congruency be deficient, operators may fail to share with owners capital expenditure ideas that significantly serve owner interests, but are minimally aligned to their interests.

By exploring hotel owner-operator contractual relations, this study contributes to agency theory, as it focuses on exposing contractual problems arising when an agent (hotel operator) has the capacity to act in a self-interested manner that is inconsistent with the principal's (hotel owner) interests (Berle & Means, 1962; Jensen & Meckling, 1976). The agency model has been employed in a wide variety of business settings concerned with a range of issues, e.g., vertical integration (Walker & Weber, 1984), executive compensation (Baker, Jensen, & Murphy, 1988), and tender offers (Cotter & Zenner, 1994). It has also been applied in a range of disciplinary contexts, e.g., accounting (Demski & Feltham, 1978), marketing (Basu, Lai,

Srinivasan, & Staelin, 1985) and organisational behaviour (Eisenhardt, 1988)). This study concerns the owner-manager agency relationship which has been the dominant focus in agency theory based studies (Eisenhardt, 1989; Walsh & Seward, 1990).

The authors are not aware of any prior academic work that provides a systematically conducted expose of the relative merits of hotel operator incentives used widely in hotel management contracts. We are also not aware of any prior consideration given to the extent to which ROI and residual income may represent preferable bases upon which to base hotel operators' fees. This paper's primary contribution is to provide a systematic examination of the shortcomings of conventional performance measures used to determine hotel operator fees and to advance the case that ROI and residual income represent alternative performance bases that would result in heightened levels of owner-operator goal alignment. The rationale provided offers considerable potential to stimulate further debate into hotel owner-operator contracting and to change the structure of operator fee incentive terms widely used in hotel management contracting. The paper can also be seen as representing a particular contribution to the application of agency theory in the hotel management context.

The remainder of the paper is structured as follows. The next section summarises findings of prior research suggesting increasing use of hotel management contracts. This is followed by an examination of the widespread use of operator fee determinants and also termination clause performance measures that undermine owner-operator capital expenditure goal congruency. An examination of the relative merits of return on investment and residual income as alternative operator fee incentive bases is then provided. The final section provides a concluding discussion and some suggestions for further research designed to extend insights concerning the dynamics of hotel management contracting provided herein.

GROWING INCIDENCE OF MANAGEMENT CONTRACTS

Regardless of how a hotel's assets are owned, hotel owners face a number of choices regarding their operating structure. In many cases, the party that owns a hotel does not operate the hotel (Hayes & Ninemeier, 2004). Considered internationally, the three main hotel operational methods are the owner-operator, franchise agreement and management contract (Gannon & Johnson, 1997).

Hotel owners that choose to operate their hotel avoid any loss of control over day-to-day operations (Field, 1995). The use of the owner-operator hotel ownership structure is, however, dwindling in many developed Western markets, such as the U.S., Europe, Australia, and New Zealand (Gross-Turner, 1999; Ingram & Baum, 1997; P. Jones, 1996; Phillips, 2003; Slattery, 1992). Further, there is little use of the hotel owner-operator structure in the burgeoning economies of India, China, and other parts of Asia (Haast, et al., 2006). As a result, usually only 'flagship' properties remain independently owned and operated (Gannon & Johnson, 1997).

Garcia-Falcon and Medina-Munoz (1999, p. 106) define hotel franchising as an arrangement where:

For a fee, an independent hotel [i.e. owner-operator] adopts the franchiser's name and trademarks and receives services in return, including the preparatory steps of feasibility, site selection, financing, design, and planning. Almost all the advantages of the chain are available for the franchisee: mass purchasing, management consultation, wide advertising, central reservations, and systems designs.

Despite relatively high franchising fees, studies show that in both developed and emerging markets, conditions are more supportive of franchising arrangements than owner-operator structures (see e.g. Fladmoe-Lindquist & Laurent, 1995; Huszagh, Huszagh, & McIntyre, 1992; Kedia, Ackerman, Bush, & Justis, 1994; Shane, 1996).

Despite the well-established franchising model, recent surveys show that the third main hotel operational approach, the management contract, has become the most popular of the three options. The separation between ownership and management through the use of a hotel management is now widespread (Beals & Denton, 2005; Corgel, 2007; Panvisavas & Taylor, 2006) and is one of the driving mechanisms for the rapid internationalisation of hotels (Beattie, 1991; Dave, 1984; Dunning & McQueen, 1981; Eyster, 1997; Litteljohn, 1991; Litteljohn & Beattie, 1992). Table 1 highlights the predominance of the management contract across North America, Europe and Asia in the late 1990s. Further, Slattery (1996) noted 75% of listed Asian hotels operating under a management contract. Contractor and Kundu (1998) found 41% of US hotels had a management contract, while Smith Travel Research (2003) noted an increase to 55%. Beals and Denton (2005), Panvisavas and Taylor (2006), and Corgel (2007) have provided further recent testimony to the increasing popularity of management contracts.

INSERT TABLE 1 ABOUT HERE

A management contract is essentially a written agreement between an owner and operator where the operator is appointed to operate and manage the hotel in the name of, on behalf of, and for the account of the owner. The contract includes a description of the operator's

remuneration fee determination (Schlup, 2004). It enables a hotel owner to retain legal ownership of the hotel site, building, plant and equipment, furnishings and inventories, while the operator assumes responsibility for managing the hotel's day-to-day business (Guilding, 2003).

Management contracts do suffer, however, from some drawbacks. A fundamental problem concerns agency challenges, as the divorce of ownership and operation can create a volatile mix of economics and power manifested due to differing owner-operator time horizons (Beals, 1995; Beals & Denton, 2005). It is generally held that operators focus on short-term cash flows while owners have more of a long-term orientation (Guilding, Kennedy, & McManus, 2001; Lynch, 2002). This tension is widely referred to as the 'horizon problem' (Dechow & Sloan, 1991; Ittner, Larker, & Rajan, 1997; B. Johnson, 1987; Smith & Watts, 1982) and can lead agents to promote low net present value (NPV) projects yielding relatively high short-term accounting earnings at the expense of higher NPV projects that yield lower short-term accounting earnings (Baber, Kang, & Kumar, 1998). Operators also tend to focus on maximising their brand values and the longevity of their management contracts in order to increase the room stock under their management (Beals & Denton, 2005; Haast, et al., 2006; Schiff, 2006). With regard to the brand value maximisation incentive, it is notable that a large proportion of a hotel company's assets are made up of goodwill associated with their brand name (Dev, Morgan, & Shoemaker, 1995). The importance of hotel brand value signifies that operators have an incentive to support capital expenditures that are consistent with projecting a favourable brand image, even though the expenditure may provide limited equity value enhancement for the hotel owner. Consider, for example, a proposed hotel lobby refurbishment. On incremental cash flow grounds, the refurbishment expenditure may not be viable. However, in terms of improved brand alignment for the

operating company, the proposed lobby refurbishment may be highly desirable. These examples of conflicting interests underscore the fact that management contracts are frequently associated with owner-operator agency conflict (Dimou, Chen, & Archer, 2003).

MANAGEMENT CONTRACTS AND OWNER-OPERATOR CAPITAL EXPENDITURE GOAL CONGRUENCY

Due to the considerable agency issues arising in the hotel management contract context, an owner's choice of operating company and the exact terms of a contract are among the most critical factors determining a hotel's long-term success (Horwath, 2006). Armitstead and Marusic (2006) note the imperative of designing management contracts that engender goal congruence. Berger (1997) comments on the particular importance of the operator's remuneration basis, which can be a source of significant tension between the contracting parties.

An operator's remuneration is widely referred to as a 'management fee' (Rushmore, 2002). Three basic management fee structures are found in practice: (1) a base fee only; (2) an incentive fee only; or (3) a base fee combined with an incentive fee (Goddard & Standish-Wilkinson, 2002). The combination of a base and incentive fee is the most common.

With respect to the combined base and incentive fee structure, it has been conventional to view the base element as covering the management company's operating expenses, while the incentive fee contributes to the operator's profit (Rushmore, 2002). While the base fee can be a fixed amount, it is most usually determined as a percentage of gross revenue. This signifies that the term 'base fee' is something of a misnomer, as it is a variable amount that might be

better viewed as an ‘incentive fee’, providing operators with an incentive to increase hotel revenue. Table 2 summarises the findings of prior studies concerned with ascertaining how hotel operator base fees are determined. It is evident from this table that internationally, the majority of management contract base fees are determined by gross revenue.

INSERT TABLE 2 ABOUT HERE

The continued widespread popularity of revenue determined operator base fees appears somewhat surprising given Feldman’s (1995, p. 43) comment that they provide an incentive for operators to “blithely recommend expenditures that increase top-line revenues that never drop to the bottom line.” Two further noteworthy implications arise from remunerating operators based on hotel revenue:

1. Aligned to the issue noted by Feldman, operator remuneration based on revenue provides the operator with an incentive to promote capital expenditure proposals that maximise revenue, without necessarily positively impacting on profit. An operator with a base fee incentive of maximising revenue might attempt to promote a capital expenditure proposal that will increase revenues by 20% and carry a negligible (or even negative) impact on profit, at the expense of an alternative proposal that will increase revenue by 5% and profit by 10%.
2. An operator with a remuneration based on revenue would have no incentive to initiate cost saving hotel capital expenditure proposals. An example of a cost saving capital expenditure that carries no implication for revenue would be the option of upgrading laundry facilities that will result in less laundry labour hours worked, reduced maintenance costs, reduced laundry detergent costs, reduced water consumption and reduced wear and tear to laundered items. Although this type of proposal may have

the potential to carry a major positive impact on profit, the absence of an effect on revenue may cause an operator with a revenue maximising inducement to exclude it from capital expenditure proposals submitted to a hotel owner.¹

Table 3 summarises prior research findings concerned with the determination of operator incentive fees. From this table it is apparent that most incentive fees are based on either a percentage of gross operating profit (GOP), GOP minus specific charges, cash flow or cash flow minus specific charges. There is a small incidence of incentive fees based on GOP relative to gross revenue, appreciated value of property, percentage above an owner's priority return, a percentage of GOP that exceeds a base fee amount, a percentage of net operating profit (NOP) over a fixed amount, or a percentage of the amount by which cumulative cash flow exceeds a cumulative set aside amount.

INSERT TABLE 3 ABOUT HERE

Emphasis attached to profit when determining an operator's incentive fee appears to have considerable potential to promote capital expenditure dysfunctionism. Consider the case of two mutually exclusive projects: project A requiring an initial investment of \$1,000,000 and projected to return \$50,000 per annum, and project B requiring an initial investment of \$500,000 and projected to return \$45,000 per annum. If an operator is remunerated according to a profit based incentive fee, it will prefer project A as it generates the highest profit. However, project B provides a superior return on investment of 9% ($\$45,000 \div \$500,000 \times$

¹ These two implications (i.e., promoting revenue maximising projects with no regard given to profit impact, and no incentive to pursue cost cutting projects) will be mitigated where a hotel management contract also provides a separate profit based incentive. Nevertheless, even the presence of a small proportion of an operator's fee based exclusively on revenue will introduce a bias causing the operator to weight the importance of revenue maximisation more heavily than cost minimisation or profit maximisation. As the proportion of an operator's total remuneration that is revenue based is increased, so too will the extent of this bias.

100) compared to project A's 5% ($\$50,000 \div \$1,000,000 \times 100$). Prior to taking this investment appraisal methodological analysis further, this simple scenario provides a clear indication that a hotel owner is likely to prefer project B, while an operator remunerated on a basis linked to profit can be expected to prefer project A.

As already noted, Table 3 highlights that some hotel operators' remuneration is based on GOP or cash flow minus one or more charges relating to asset investment. Remuneration bases that involve these types of deduction appear to provide a better basis for promoting owner-operator capital expenditure goal alignment. This is because they represent algorithms affording recognition to asset involvement in profit generation. Charges against profit or cash flow noted in Table 3 that recognise asset involvement in profit generation include: property taxes, insurance, FF&E (furniture, fittings and equipment) reserve allocation, and debt service.

With respect to making a charge for the FF&E reserve allocation, it is noted by Schlup (2004) that because the adequate maintenance of a hotel is also in the best interest of the operator, it appears fair that contributions to the FF&E reserve be treated as operating expenses, signifying a reduced fee paid to operators remunerated on a profit basis. Understanding the implication for an operator when FF&E reserve allocations are deducted from the profit figure used in determining incentive fee payments is complicated, however. To appreciate this we need to recognise that the FF&E reserve allocation is generally set at around 3% of gross revenue (Brooke & Denton, 2007; Phillips, 2003; Ransley & Ingram, 2001). Consider the case of a hotel operator evaluating a capital expenditure opportunity that will provide a \$1,000 increase in revenue. If the operator is paid a 3% of gross revenue base fee, they stand to benefit by \$30 (3% of the \$1,000 increase in revenue). With respect to the operator's

incentive fee, if the fee is based on profit minus a charge for FF&E reserve allocation and if the allocation is set at 3% of gross revenue, then an additional \$30 (3% of \$1,000) will be allocated to the FF&E reserve and deducted from the profit basis used for determining the incentive payment. Say that 10% of the adjusted profit is being provided to the operator as their incentive fee, the result of the \$1,000 increased revenue on the incentive fee paid is a reduction of only \$3 ($\$1,000 \times 3\% \times 10\%$).² This worked example highlights the extent to which deducting FF&E reserve allocations from GOP used in determining operator incentive fee payments contributes minimally to greater owner-operator capital expenditure goal congruency. Further, it is notable that the amount allocated to FF&E reserve does not represent a good proxy for FF&E capital expenditure, as it is widely noted that FF&E reserve contributions fall some way short of the average annual capital expenditure required to maintain FF&E (Barge & Jacobs, 2001; Brooke & Denton, 2007; Eyster, 1988, 1997; Ferguson & Selling, 1985; Haast, Dickson, & Braham, 2005; Mellen, Nylen, & Pastorino, 2000; Ransley & Ingram, 2001; Reichardt & Lennhoff, 2003).³

Of the asset related deductions from GOP that are noted in Table 3, making a charge for debt service and return on equity both appear to lay the basis for greater owner-operator capital expenditure goal congruency relative to an FF&E reserve allocation linked deduction. This is because they both represent an explicit charge for the full cost of any capital outlays made, signifying an operator incentive to minimise an owner's capital outlay.⁴

² In the interests of parsimony, we have assumed that the \$1,000 increase in revenue has not resulted in a change in profit. This simplifying assumption does not affect the rationale outlined.

³ It is notable that widely deployed long-term loan restrictive covenants impose FF&E reserve contribution requirements on hotel owners as a means of protecting lender interests.

⁴ It should be noted that charges for debt and equity appear to be little used outside the U.S. Discussions with a specialist in the preparation of Australian hotel management contracts indicate that it is very rare for capital employed charges (whether relating to debt or equity) to be included in the calculation of the profit basis used to determine an operator's incentive fee.

A second dimension of the management contract drawing on accounting metrics to promote owner-operator goal alignment concerns performance standards which, if not met, can be invoked by an owner as grounds for contract termination (Dutta, 2003; Haktanir & Harris, 2005). This aspect of contracting can be a source of significant owner-operator conflict (Beals & Denton, 2005). Despite this, the deployment of minimum performance standards in hotel management contracting is expected to increase commensurate with rising hotel operator competition levels (Goddard & Standish-Wilkinson, 2002; Harris & Mongiello, 2001; Rainsford, 1994). It is widely noted, however, that exclusive use of performance measures is unlikely to curb potential dysfunctional operator behaviour, because owners have limited capacity to extract all private information pertaining to performance (Baiman, 1990; Baiman, Evans, & Noel, 1987; Magee, 1980). The findings of prior empirical research appraising the nature and incidence of operator performance measures are summarised in Table 4.

INSERT TABLE 4 ABOUT HERE

The only measures documented in Table 4 that have not already been considered are occupancy and revenue per available room (RevPAR). The relative merits of each are outlined in the hospitality management accounting normative literature (e.g. Jagels, 2007; Schmidgall, 2006). With respect to their implications for capital expenditure decision making, consistent with the rationale already outlined, occupancy and RevPAR both suffer from no recognition of capital outlay. If appraised on RevPAR and occupancy, an operator would have an inducement to rank a \$50,000 capital expenditure opportunity that results in a 2% increase in occupancy and \$5 increase in RevPAR behind a \$1,000,000 outlay that results

in a 3% increase in occupancy and \$6 increase in RevPAR. Although the first option can be expected to provide the higher return on investment, it yields the lower occupancy and RevPAR. It should also be noted that emphasis on occupancy and RevPAR performance measures would likely raise the priority attached by an operator to accommodation related capital expenditures relative to expenditure on other hotel activities such as restaurant and bar.

Where an operator is performing poorly, the only other termination option for an owner is to invoke termination without a cause provisions. Prior research findings concerned with appraising the incidence and nature of such provisions are summarised in Table 5. This table highlights that around one-third of management contracts include termination without a cause provisions. Consistent with the challenge of activating operator performance measures, termination without a cause provisions are becoming increasingly difficult to invoke because of their extensive qualifications and caveats (Dickson, 2007). This underscores the importance of ensuring that a negotiated management contract is conducive to a high degree of owner-operator goal alignment. Management contract termination impediments in combination with deficient owner-operator goal congruence signify a high propensity for protracted hotel operational decision-making that is inconsistent with owner interests.

INSERT TABLE 5 ABOUT HERE

RETURN ON INVESTMENT AND RESIDUAL INCOME AS ALTERNATIVE DETERMINANTS OF OPERATOR FEES

The foregoing analysis has highlighted widespread use of hotel operator remuneration bases that appear deficient with respect to promoting owner-operator capital expenditure goal congruency. We now turn to consider alternative performance measures that, a priori, represent inducement bases more consistent with promoting owner-operator capital expenditure goal congruency.

Generally accepted finance practice holds that the preferred investment appraisal criterion is NPV and that capital expenditure proposals are justifiable if they yield a projected positive NPV (Butler, Davis, Pike, & Sharp, 1993; Payne, Carrington-Heath, & Gale, 1999). Formulation of a NPV calculation requires the provision of projected cash flows. NPV would not be a good basis for determining hotel operator management fees, however. This is because operator management fees need to be based on objectively verifiable performance measures. Monitoring past achievements involves much less subjectivity than projected cash flow formulation. So although NPV is the preferred approach for evaluating capital expenditure proposals, it does not lend itself to gauging a hotel operator's performance.

Two measures of past performance that give recognition to the amount of investment involved in generating a return and are widely discussed in the management accounting literature are return on investment (ROI) and residual income (RI) (Anthony & Govindarajan, 2007; Langfield-Smith, Thorne, & Hilton, 2003).⁵ Formulae for these measures follow:⁶

$$\text{ROI} = \text{Operating profit} \div \text{Operating assets}; \text{ or } \text{Operating profit} \div \text{Sales} \times \text{Sales} \div \text{Operating assets}$$

⁵ Residual income formulations often appear under various names such as abnormal earnings (Ohlson, 1995) or Economic Value Added (EVA[®]), which is a technique popularised by the consulting firm Stern Stewart & Co (Anthony & Govindarajan, 2007; Biddle, Bowen, & Wallace, 1997; Chen & Dodd, 1997; Wallace, 1997).

⁶ It should be noted that, in practice, there can be much variation in the way that companies define profit and assets. Profit can be profit before or after tax, earnings before interest and taxes (EBIT) or net profit. While assets may be defined as total assets or assets minus current liabilities.

$$RI = \text{Operating profit} - (\text{Cost of capital} \times \text{Operating assets})$$

It can be seen from these formulae that ROI constitutes a ratio, not an absolute dollar amount. It has become commonplace for normative expositions of ROI in the management accounting literature (e.g. Anthony & Govindarajan, 2007; Horngren, Datar, & Foster, 2007) and the hospitality management accounting literature (e.g. Guilding, 2009) to demonstrate how ROI can be dissected into two underlying components: profit margin ($\text{profit} \div \text{sales}$) and sales turnover ($\text{sales} \div \text{assets}$). It is evident that there is some convergence between the profit margin element of ROI and conventional hotel operator incentives, due to the latter's emphasis on sales and profit. The element that is completely lacking, however, is the incentive to maximise sales for a given level of investment, as conventional operator incentives lack a measure that taps into the investment construct. RI is calculated as profit minus an imputed charge for capital employed. The imputed charge is generally linked to the cost of capital (Langfield-Smith, et al., 2003).

The major benefit of ROI is that the agent is discouraged from excessive investment in assets.⁷ Further advantages of ROI include: (1) it reflects anything that affects the financial statements; (2) it is easy to calculate, simple to understand, and is meaningful in an absolute sense; (3) it can be applied to any unit within an organisation responsible for profitability, regardless of the size or type of the business; and (4) as ROI data is typically available for competitors, it can be used as a basis for comparison (Anthony & Govindarajan, 2007).⁸ A

⁷ The merit of ROI is apparent from the following comment provided in a lodging sector company's 10-K Report: "Return on invested capital is a key profitability measure that provides an indication of the long-term health of our concepts. This metric is based on a comparison of operating profit to the average capital invested in our restaurants. We believe return on invested capital is a critical indicator in evaluating our ability to create long-term value for our shareholders." (P.F. Chang's China Bistro Inc, 2008, p. 21).

⁸ Attempting cross company ROI comparisons is not straight forward, however, as the useful lives of depreciable assets will differ across hotels. As assets become fully depreciated, the measure of investment declines and ROI increases, undermining the merit of attempting cross hotel ROI comparisons.

major disadvantage of ROI is that it can encourage agents to defer asset replacement and also discourage agents from investing in some capital projects that are viable from an owner's perspective, as will be seen below (this is sometimes referred to as an "underinvestment problem"). A second disadvantage is that managers evaluated on the basis of ROI may be dissuaded from investing in some positive NPV projects. This is because such projects may have low levels of profit and ROI in the early years of their useful lives. Consistent with most other accounting measures, a third disadvantage of ROI is that it does not represent an economic rate of return on capital, because accounting profit excludes many value increases such as land appreciation prior to sale, as well as intangible asset growth such as increases in brand value.

RI has been widely promoted as a measure that averts some of ROI's shortcomings (see Anthony & Govindarajan, 2007; Christensen, Feltham, & Wu, 2002; Dutta & Reichelstein, 2002; Langfield-Smith, et al., 2003). RI's improvement over ROI stems from its formula containing an important piece of data that is absent from the ROI formula, ie, the organisation's required rate of return on invested capital (Langfield-Smith, et al., 2003).⁹ Despite the theoretical strength of RI, Drury, Braund, Osborne, and Tayles (1993) note that surveys (e.g. Reece & Cool, 1978; Scapens, Sale, & Tikkas, 1982; Skinner, 1990) have indicated that practitioners show a strong preference for ROI because: (1) as a ratio, it can be used for comparisons within or between divisions; (2) ROI can be compared with other organisations or within an organisations' divisions; and (3) ROI is generally considered a measure of overall profitability and is therefore used more by outsiders.

⁹ A hotel's required rate of return on invested capital is its cost of capital. In a hospitality management context Guilding (2009, p. 297) notes "the cost of capital is the average cost (stated as a percentage) of the capital funds raised by a company". Viewed slightly differently, it is the rate of return that a company must earn in order for its market value to remain unchanged (assuming a steady stock market).

In a hotel management investment decision making context, Guilding (2009, pp. 177-178) demonstrates how RI represents a preferred incentive basis to ROI. The case he depicts is reproduced as Table 6. The top panel provides the current scenario of a hotel chain with two hotels: Hotel A generating a 4% ROI and -\$30,000 RI, and Hotel B generating an 18% ROI and \$40,000 RI. The hotel chain is seeking a 10% target ROI. Options that have arisen for the two hotels are outlined in the table's second panel and the ROI impact of acting on these options is outlined in the third panel. Hotel A has an incentive to purchase an asset costing \$200,000 as it would increase its ROI from 4% to 5.4% ($\$38,000 \div \$700,000 \times 100$). Hotel B has an incentive to sell an asset that generates \$21,600 for its \$180,000 book value, as the hotel's ROI would increase from 18% to 21.4% ($\$68,400 \div \$320,000 \times 100$). The flaw in the ROI incentive becomes apparent when it is recognised that the hotel chain is preparing to buy an asset that will earn a 9% ROI ($\$18,000 \div \$200,000$) while at the same time selling a second asset earning a higher ROI of 12% ($\$21,600 \div \$180,000$). This problem is averted if RI maximisation is adopted as the performance measurement criterion. As is evident from Table 6's final panel, if Hotel A were to make the \$200,000 asset purchase, its RI would drop from -\$30,000 ($\$20,000 - (0.1 \times \$500,000)$) to -\$32,000 ($\$38,000 - (0.1 \times \$700,000)$). If Hotel B were to make the \$180,000 asset sale, its RI would drop from \$40,000 ($\$90,000 - (0.1 \times \$500,000)$) to \$36,400 ($\$68,400 - (0.1 \times \$320,000)$). The decline in the two hotels' respective RIs signify that neither should make the asset changes under consideration.

INSERT TABLE 6 ABOUT HERE

When applying the RI algorithm, any investment that exceeds an organisation's required rate of return yields a positive RI. As a result, RI motivates managers to maximise profits from the resources that they have at their disposal and to only invest in additional resources when the investment will produce an adequate return (Anthony & Govindarajan, 2007). Appendix A presents a simulated exercise that demonstrates how RI represents a performance measurement basis that promotes a higher degree of owner-operator capital expenditure goal congruency compared to traditional hotel operator fee bases that are tied to revenue and profit.

It was noted above that finance practice holds that the preferred investment appraisal criterion is NPV. It is noteworthy, therefore, to recognise that RI, considered over the long term, approximates to NPV. Using RI to evaluate management performance can be expected to promote goal congruency, because the information that is required for NPV and IRR converges (considered over the long term, accruals based differences between cash flows used in NPV calculations, and profit which is used in RI calculations, disappear). We can thus conclude that maximizing RI over time approximates to maximizing firm value.

Analysis of hotel management contracts in the U.S. provides some support for the view that RI represents a preferred basis for determining hotel operator remuneration. Eyster's (1993) study cites examples of contracts where the basis for the remuneration fee is GOP (or cash flow) adjusted for items such as debt service and return on equity. Adjusting profit for debt service can be seen as a 'partial RI' measure, for although it embodies a charge for debt capital, no charge is made for equity funding. For the 5.9% of contracts examined by Eyster where the operator remuneration is based on cash flow after debt service and return on equity, we have a closer approximation to RI. This is because the measure involves a charge made

for all long-term capital funding (i.e. equity and debt). While this signifies the existence of some management contracts promoting a better alignment of owner-operator capital expenditure interests, this improved alignment will be largely negated if this type of incentive fee is combined with a base fee determined by gross revenue (the most common base fee noted in Table 2). More recent hotel management contract surveys (e.g. Barge & Jacobs, 2001; Goddard & Standish-Wilkinson, 2002; Haast, et al., 2005; K. Johnson, 1999; Panvisavas & Taylor, 2006) have failed to identify any incentive fees tied to cash flow after debt service and return on equity.

With respect to the adoption of RI as a generic performance measure, Balachandran (2006) conducted an analysis of Compustat firms' RI usage. Table 7 provides an industry sector classification of Balachandran's RI adoption findings. The proportion of firms using RI measures ranged from 34.8% of durable goods firms to 0% of real estate firms. Considered holistically, these findings suggest limited application of RI across a range of industrial settings.

INSERT TABLE 7 ABOUT HERE

Although this study promotes using RI as a basis for determining operator fees, it should be noted that it is not devoid of shortcomings. RI is a financially denominated measure that is calculated from accrual accounting numbers. Performance measures that are based on accounting numbers are widely criticised for instilling a short-termist outlook (Ezzamel, 1992; Ezzamel & Hart, 1989; Rappaport, 1986). In light of this, many commentators suggest combining financial and non-financial performance measures in an attempt to better align the interests of principals and agents (Aggarwal, 1991; Kakati & Dhar, 1991; Slagmulder &

Bruggeman, 1992).¹⁰ If attempting to use RI in a cross hotel comparison, it must be recognised that it is an absolute number, and larger hotels would be expected to generate a higher residual income than smaller hotels, although this problem can be circumvented by using a hybrid measure that sees RI divided by assets employed. Consistent with other accounting based measures, RI measures performance within a one year window. This year's measure does not capture impacts occurring in subsequent years that stem from actions taken this year. For example, reducing maintenance or marketing to achieve a target profit may increase the current period's RI, but jeopardise future hotel value.

A further shortcoming of using ROI or RI relates to Healy's (1985) bonus plan hypothesis. Healy (1985) explains how the remuneration conditions existing between a principal and agent can cause the agent to make profit increasing or decreasing accounting policy choices. If ROI or RI is used to incentivise an operator, and profit in a particular year is negative, the operator may be induced to 'take a bath' by selectively expensing any potential future capital expenditure in the current period, to reduce capital charges assigned to future years. Given the high asset base associated with hotels, there appears to be considerable scope to manipulate the period in which substantial expenses are charged. Generally Accepted Accounting Principles (GAAP) and hotel management contracts provide little guidance resolving the issue concerning which asset related expenditures are to be expensed or capitalised (Schmidgall, Damitio, & Singh, 1997). Research examining Healy's (1985) hypothesis provides equivocal results, however. Studies supporting Healy's hypothesis include (see Bernard & Skinner, 1996; Dechow, Sloan, & Sweeney, 1995; Holthausen, Larcher, & Sloan, 1995; J. Jones, 1991; Kaplan, 1985; McNichols & Wilson, 1988; Schipper,

¹⁰ Non-financial performance measures, for example, can include market share (Morishima, 1982; Prestowitz, 1988; Tsuruni, 1984; Van Wolferen, 1989); innovativeness (Goldsmith & Clutterbuck, 1984); market standing (Saunders & Wong, 1985); efficiency / productivity, product quality, customer satisfaction, employee satisfaction (Ittner, et al., 1997), and others.

1989). Research providing conflicting evidence includes (see DeFond & Park, 1997; Gaver, Gaver, & Austin, 1995).

While the discussion in this section has been conducted in the context of seeking improved bases of hotel operator fee determination, it is also pertinent to identify appropriate performance measure thresholds that can be invoked by an owner as grounds for contract termination. Based on the rationale outlined, it would appear to be in owners' interests to require operators to meet performance thresholds stated in terms of ROI or RI.

CONCLUSION AND DISCUSSION

In any discussion of accounting measures that can be used as a basis of hotel operator fee determination, it is important to recognise the role that operator brand standards can play in hotel capital expenditure decision making (Beals & Denton, 2005; Haast, et al., 2006; Schiff, 2006). If an owner deems a particular capital expenditure proposal to be unjustifiable on financial criteria grounds, but the operator sees the expenditure as necessary to meet their brand standard, if the owner rejects the proposal, the operator may have the right to terminate the contract (Beals & Denton, 2005). In such a situation, although use of ROI or RI might suggest that the operator's capital expenditure interest is well aligned to the owner's interest, there is a strong brand standard factor at play that affects the operator's capital expenditure perspective. Although a proposed expenditure may have a negative ROI or RI (thereby potentially reducing an operator's incentive management fee), the operator may still support the expenditure if the benefit to their brand value outweighs any potential management fee reduction.

This paper has demonstrated that widely used clauses in hotel management contracts provide an incentive for hotel operators to take actions consistent with maximising sales and profits, but not maximising return on investment. As the hotel management contract is ubiquitous in the Western World, this propensity to make management decisions on the criteria of maximising sales and profits without due regard given to capital employed can be expected to be a systemic feature of Western World hotel management. This signifies a potential systemic misallocation of effort and resources in the international hotel sector on a mass scale and appears worthy of further academic enquiry. From a practitioner perspective, the paper can be expected to be of particular interest to hotel owner groups such as the *Asian American Hotel Owners Association*, which has been active in furthering owner's interests through activities such as promotion of the fair franchising initiative.¹¹

A potential line of research enquiry extending the current study's focus could examine the nature of a General Manager's engagement in hotels operating with a management contract. It is usual for the operator to engage the General Manager (Eyster, 1997; Guilding, 2003, 2006; Rushmore, 2002). In most cases, however, this appointment requires the approval of the owner (Guilding, 2003; Haast, et al., 2005). It is noteworthy that in some situations the owner pays for the General Manager's salary immediately (Dickson & Williams, 2006), while in other situations the salary is initially paid for by the operator but is eventually reimbursed by the hotel owner (Eyster, 1997; Guilding, 2003). Regardless of which method is adopted, the owner's financing of the General Manager's salary continues throughout the entire term of the management contract. In some management contracts, the owner also has the authority to remove the General Manager for unacceptable performance (Crandell, Dickinson, & Kanter, 2004). Clearly, such an employment arrangement gives rise to conflict

¹¹ Further information can be found at: <http://www.aahoa.com>

because it detracts from the operator's degree of control over the General Manager, i.e., the General Manager feels accountable to the owner as well as the operator. Given the key role a General Manager plays in capital budget formulation (Rushmore, 2002), understanding the relative motivations of General Managers and the way they manage tensions between owners and operators would likely sharpen our appreciation of the dynamics at play in hotel capital budgeting. Should research be made of performance related pay of General Managers, it would be useful to determine if hotels are effective in distinguishing between the performance of a manager and the performance of a hotel, as a hotel may be a poor performer that is affected by economic conditions beyond a manager's control.

Further research could also examine factors arising from the growing incidence of owner engagement of asset managers to monitor operators (Armitstead, 2004; Bader & Lababedi, 2007; Geller, 2002). This development appears to parallel growing owner realisation of inconsistencies between owner and operator interests (Feldman, 1995; Johnstone & Duni, 1995). Although asset manager engagement is designed to promote improved owner-operator interest alignment (Bader & Lababedi, 2007), it is notable that asset managers are traditionally recruited from the ranks of hotel management companies, where they have been previously employed as General Managers or Vice Presidents. As a result, asset managers' often focus on short-term operational issues rather than building long-term value (Bridge & Haast, 2004). Field study research into issues surrounding the degree to which asset managers promote owner-operator goal congruency has the potential to provide profound insights into the mechanics of hotel capital expenditure management.

Research could also be directed towards determining the extent to which hotel owners are requiring operators to take an equity stake in the ownership of the properties that they

manage, as a mechanism to promote greater owner-operator goal congruency. An examination of the extent to which this represents a viable and productive means for promoting increased owner-operator goal congruency would provide a useful contribution to our understanding of the likely evolution of owner-operator contracting.

Modal choice	North America	Europe	Asia
Owner-operator (fully owned)	9.46	28.60	22.40
Owner-operator (partially owned, e.g. joint venture)	11.46	6.20	22.93
Franchise agreement	38.31	28.66	12.45
Management contract	40.76	36.53	42.21

Adapted from: Contractor and Kundu (1998)

TABLE 2 Prior Research into the Calculation of Hotel Operator Base Management Fees				Determinant of base fee and typical amount		
Author	Geographic focus	Contracts analysed	% incidence			
Eyster (1988)	U.S. (58 contracts) & international (19 contracts)	77	55.8	Gross revenue (2 – 7%)		
			10.4	Fixed amount (US\$800,000 - \$1,400,000 per year)		
			6.5	Percentage of room revenues (3 – 5%) and of food and beverage revenues (3 – 5%)		
			3.9	Gross revenue (4 – 6%), with portion of fee subordinated to cash flow after debt service (1 – 2%)		
			13.0	No base fee		
Eyster (1993)	U.S.	17	58.8	Gross revenue (1.5 – 4%)		
			23.5	Fixed amount (US\$36,000 – \$180,000/year)		
			11.8	No base fee		
Sangree and Hathaway (1996)	U.S.	32	-	Gross revenue (2.9% mean)		
			94.4	Gross revenue (1 – 6%)		
Eyster (1997)	U.S.	18	5.6	Fixed amount (unspecified) + gross revenue (1.5 – 3%)		
			96.0	Gross revenue (2.7% mean)		
Johnson (1999)	U.S.	50	2.0	Fixed amount (did not specify)		
			2.0	No base fee		
			66.0	Gross revenue (1.5% mean)		
			26.0	Sliding scale (% of gross revenue) / Mixed (% of gross revenue & divisional revenue) / Fixed		
Barge and Jacobs (2001)	Asia-Pacific (Australia included)	50	8.0	No base fee		
			66.7	Gross revenue (1.8% mean)		
			25.0	Sliding scale (% of gross revenue) / Mixed (did not specify basis) / Fixed		
			8.3	No base fee		
			78.6	Gross revenue (2.7% mean)		
	Americas		28	14.3	Gross revenue sliding scale (2.7% mean, after stabilisation)	
				3.6	Fixed fee (did not specify)	
				3.6	No base fee	
				44.4	Total revenue (1 – 3%)	
				33.3	Gross revenue (1.5 – 2.0%)	
Goddard and Standish-Wilkinson (2002)	Middle-East	9	22.2	No base fee		
			64.3	Gross revenue (1.4% mean)		
			17.9	Gross revenue sliding scale (1.4% mean, after stabilisation)		
			17.9	No base fee		
			62.1	Gross revenue (2.2% mean)		
Haast, Dickson, and Braham (2005)	Europe	29	34.5	Sliding scale (% of gross revenue) / Mixed (did not specify basis) / Fixed		
			3.4	No base fee		
	Americas		28	85.7	Gross revenue (2.8% mean)	

			14.3	Gross revenue sliding scale (2.8% mean, after stabilisation)
Panvisavas and Taylor (2006)	Thailand	8	-	Gross revenue (1 – 6%)

TABLE 3
Prior Research into the Calculation of Hotel Operator Incentive Management Fees
Determinant of incentive fee and typical amount

Author	Geographic focus	Contracts analysed	% incidence	
Eyster (1988)	U.S. (38 contracts) & international (19 contracts)	77	24.7	GOP (3 – 30%).
			10.4	GOP less property taxes, insurance, and FF&E reserve allocation (8 – 20%) subordinated (or portion) to debt service (10%).
			6.5	Cash flow after property taxes, insurance, FF&E reserve allocation, and debt service (10 – 25%).
			6.5	GOP after property taxes, insurance, FF&E reserve allocation, and debt service (6 – 16%; or 5% GOP before deductions + 5% GOP after deductions).
			6.5	GOP after property taxes, insurance, FF&E reserve allocation, debt service, and return on equity charge ((10 – 15%); or 5% GOP after debt service + 5 to 10% GOP after required return on equity charge (typically 8 to 10%).
			5.2	Cash flow after property taxes, insurance, FF&E reserve allocation, debt service, and required return on equity charge ((10 – 30% (8 – 12% required ROE charge)).
			3.9	GOP (6 – 12%) + percentage of cash flow after property taxes, insurance, FF&E reserve allocation, and debt service (10 – 25%).
			2.6	Dollar amount by which GOP before fixed charges percentage amount exceeds gross revenues.
			2.6	GOP (8 – 15%) + percentage of cash flow after property taxes, insurance, FF&E reserve, debt service, and return on equity charge ((20 – 40% (7 – 10% ROE charge)).
			19.5	No incentive fee
Eyster (1993)	U.S.	17	29.4	GOP (5 – 15%)
			17.6	Cash flow after debt service (10 – 28%)
			11.8	Improvement in GOP (10 – 30%)
			5.9	Adjusted GOP (8 – 20%, adjustment not specified)
			5.9	Cash flow after debt service and return on equity charge (18 – 30%)
			5.9	Appreciated value of property (10%)
			23.5	No incentive fee
Sangree and Hathaway (1996)	U.S.	32	Most common	Percentage increase in GOP compared to a predetermined figure (14.0% mean)
			Common	GOP (7.9% mean)
			Common	Percentage beyond an owner's priority return (17.1% mean)
			Less common	Percentage of GOP that exceeds a base-fee amount (did not specify)
			Less common	Percentage of NOP over a fixed amount (did not specify)
Eyster (1997)	U.S.	18	Less common	Percentage of the amount by which cumulative cash flow exceeds cumulative set-aside amount (did not specify)
			27.8	Cash flow after debt service (0 – 32%)
			22.2	Cash flow after debt service and return on equity (0 – 40%)

			22.2	Improvement in GOP (8 – 25%)
			22.2	GOP subordinated to a negotiated cash flow amount (5 – 10%)
			5.6	Improved property value (10 – 25%)
			76.0	GOP less property taxes, FF&E reserve allocation, debt service, and owner's priority return (21% mean)
			12.0	GOP less property taxes and FF&E reserve allocation (did not specify)
			8.0	GOP less property taxes, FF&E reserve allocation, and debt service (did not specify)
			4.0	GOP less property taxes (did not specify)
			4.0	No incentive fee
			42.0	GOP (8% mean)
			40.0	GOP sliding scale (5 – 10%, most popular range)
			10.0	Unspecified
			8.0	No incentive fee
			54.2	GOP (6.9% mean)
			41.7	GOP sliding scale (5 – 15% most popular range)
			4.2	No incentive fee
			21.4	Percentage of the difference between an adjusted GOP (by deducting the base management fee) and a specified percentage of the purchase price of the hotel (25 – 80% of the difference)
			21.4	Percentage of NOP over a certain threshold (unspecified)
			17.9	GOP (4%)
			39.3	No incentive fee
			77.8	GOP (8 – 10%)
			11.1	Adjusted GOP (14%, adjustment not specified)
			11.1	NOP (17.5%) but operator to receive a minimum of US\$180,000 per annum
			39.3	GOP (11.2% mean)
			35.7	GOP sliding scale (5 – 10%, most popular range)
			10.7	Other (not specified)
			14.3	No incentive fee
			31.0	Adjusted GOP by deducting the base management fee (9.2% mean)
				Profit share, which can include:
				• NOP thresholds;
				• Owner's priority return deducted from GOP; or
				• GOP targets
			20.7	GOP sliding scale (5 – 10%, most popular range)
			17.2	Other sliding scales (unspecified)
			3.4	No incentive fee
			21.4	NOP after payout of owner's priority return (20%)
			17.9	GOP (7.6% mean)
Haast, Dickson, and Braham (2005)	Europe	29		
Goddard and Standish-Wilkinson (2002)	Middle-East	9		
	Asia-Pacific (Australia included)	28		
	Americas	28		
Barge and Jacobs (2001)	Europe	24		
	Americas	28		
	Asia-Pacific (Australia included)	50		
Johnson (1999)	U.S.	50		

			21.4	Other (not specified)
			39.3	
Panvisavas and Taylor (2006)	Thailand	8	Most common	GOP (0 – 10%)

Management Contract Termination: Incidence and Nature of Operator Performance Thresholds					
Author	Geographic focus	Contracts analysed	Proportion of hotels identifying criteria for management contract termination	Performance measure	Performance threshold requirement
Eyster (1988)	U.S. (58 contracts) & international (19 contracts)	77	- 36% of chain operators that have no equity invested - 18% of chain operators with equity invested - 14% of international operators	GOP (most common)	Actual GOP is compared against the performance of other competitive properties.
				Cash flow after debt service (common)	Suitability of measure determined with reference to a comparison of projected and actual inflation rates for the period under consideration.
				Cash flow after debt service and return on equity (less common)	Suitability of measure determined with reference to a comparison of projected and actual inflation rates for the period under consideration.
Eyster (1993)	U.S.	17	- 37% of chain operators - 32% independent operators	Occupancy percentage (seldom)	Actual occupancy percentage is compared against the performance of other competitive properties.
				GOP	Agreed-upon three-to-five-year annual budgeted projections of GOP compared to actual GOP each year.
Eyster (1997)	U.S.	18	58%	GOP	Agreed-upon eight-to-ten-year annual budgeted projections of GOP compared to actual GOP each year.
				GOP	Agreed-upon annual projections of budgeted GOP compared to actual GOP each year (actual GOP must typically be 80% or more of budgeted GOP for performance to be deemed satisfactory).
				GOP	Agreed-upon annual projections of budgeted GOP compared to actual GOP each year (actual GOP compared to the trading results of three comparable hotels).
Barge and Jacobs (2001)	Asia-Pacific (Australia included)	28	Did not specify.	GOP	Agreed-upon annual projections of budgeted GOP compared to actual GOP each year.
				GOP	Actual GOP can also be compared to similar hotels in the area, established industry standards, established standards of the operator, or to a specified star rating.
				GOP	Agreed-upon annual projections of budgeted GOP compared to actual GOP each year.
Americas	Europe	50	62.1%	NOP	Actual NOP can also be compared to similar hotels in the area, established industry standards, established standards of the operator, or to a specified star rating.
				RevPAR	Agreed-upon annual projections of budgeted NOP compared to actual NOP each year.
				RevPAR	Actual NOP can also be compared to similar hotels in the area, established industry standards, established standards of the operator, or to a specified star rating.

Goddard and Standish-Wilkinson (2002)	Middle-East	9	55%	GOP		Agreed-upon annual projections of budgeted GOP compared to actual GOP each year.	
				Negotiated dollar target	Agreed-upon annual projections of budgeted GOP compared to actual GOP each year.		
Haast, Dickson, and Brahm (2005)	Asia-Pacific (Australia included)	28	57.1%	Base figure		Base figure is increased annually by CPI (Consumer Price Index, or part thereof) for the life of the contract.	
				GOP (most common)			Agreed-upon annual projections of budgeted GOP compared to actual GOP each year (actual GOP must typically be 80% or more of budgeted GOP for performance to be deemed satisfactory).
				RevPAR (less common)			
	Europe	29	50+%	GOP		Agreed-upon annual projections of budgeted GOP compared to actual GOP each year (actual GOP must typically be 80% or more of budgeted GOP for performance to be deemed satisfactory).	
				RevPAR			RevPAR is typically relative to the average of a competitive set.
				RevPAR			
Americas	28	57.1%	NOP		Must achieve a percentage of budgeted NOP		
			Owner's priority return			Expressed as a percentage or in whole dollars	
Panvisavas and Taylor (2006)	Thailand	8	Unspecified	GOP		Agreed-upon annual projections of budgeted GOP compared to actual GOP each year.	
				RevPAR			RevPAR is typically relative to a comparison of competitive properties in the same local market area.

TABLE 5 Incidence and Nature of Owner Options to Terminate Management Contract Without a Cause					
Author	Geographic region	Contracts analysed	Type of operator	Incidence % adopting	Penalty fee in relation to management fees (Base and incentive)
Eyster (1988) ¹² (<i>Empirical observation</i>)	U.S. (58 contracts) & international (19 contracts)	77	Branded	30%	At any time: 3 – 5 years After a predetermined period: After 6 months: 3 – 5 years After 1 to 2 years: 3 – 5 years After 3 to 4 years: 2 – 4 years After 5 years: 1 – 3 years
			Non-branded	53%	At any time: 1 – 5 years After a predetermined period: After 6 months: 1 - 5 years After 1 to 2 years: 3 years After 3 to 4 years: 2 years After 5 years: 1 year
Eyster (1993)	U.S.	17	Branded	22%	After a predetermined period: First 3 years - cannot terminate After 3 to 6 years: 4 years After 7 to 10 years: 3 years After 11 years: 2 years
			Non-branded	31%	After a predetermined period: First 1 to 3 years - cannot terminate After 3 to 5 years: 2 years After 6 years: 1 year
			Branded	23%	After a predetermined period: First 1 to 3 years - cannot terminate Years 2 to 4 onwards: 2 to 4 years
Eyster (1997)	U.S.	18	Non-branded	68%	At any time: 0.5 to 2 years After a predetermined period: First 1 to 3 years - cannot terminate Years 2 to 4 onwards: 0.5 to 2 years
			Branded and non-branded	33%	At any time: Most common 2.5 years
Johnson (1999)	U.S.	50	Branded and non-branded	36%	Unspecified
			Asia-Pacific (Australia included)	31%	Unspecified
			Europe	25%	Unspecified
			Americas	25%	Unspecified
Barge and Jacobs (2001)	Asia-Pacific (Australia included)	28	Branded and non-branded	25%	Unspecified
			Branded and non-branded	25%	Unspecified
Haast, Dickson, and Braham	Asia-Pacific (Australia included)	28	Branded and non-branded	25%	Unspecified

¹² Results of independent operators where their owner is in foreclosure omitted.

(2005)	Europe	29	Branded and non-branded	17%	Unspecified
	Americas	28	Branded and non-branded	23%	Unspecified

TABLE 6
Illustration of the merit of RI vs ROI

	<u>Hotel A</u>	<u>Hotel B</u>
<i>Current scenario:</i>		
Investment in assets	\$500,000	\$500,000
Operating profit	\$20,000	\$90,000
ROI (Profit ÷ Assets)	4%	18%
RI ((Profit – (Cost of capital X Assets))	-\$30,000	\$40,000
<i>Additional opportunity:</i>		
Purchase asset	\$200,000	
Sell asset		\$180,000
Change in profit	+ \$18,000	- \$21,600
ROI associated with asset purchase or sale	9%	12%
<i>ROI subsequent to asset purchase or sale:</i>		
Assets	\$700,000	\$320,000
Operating profit	\$38,000	\$68,400
New ROI	5.4%	21.4%
<i>RI subsequent to asset purchase or sale:</i>		
Assets	\$700,000	\$320,000
Operating profit	\$38,000	\$68,400
RI	-\$32,000	\$36,400

TABLE 7			
RI adoption by industry			
Industry	Number of implementers	Percent of sample	Average percent of Compustat firms
Mining and construction	6	3.2	7.7
Food	7	3.8	2.3
Textiles, printing, publishing	19	10.8	5.1
Chemicals	7	3.8	1.8
Pharmaceuticals	4	2.7	2.8
Extractive industries	3	1.6	0.5
Durable goods	63	34.8	20.1
Computers	3	1.6	9.8
Transportation	10	5.4	5.7
Utilities	17	9.7	2.4
Retail	18	9.7	10.9
Financial institutions	10	5.4	11.5
Real estate	0	0.0	8.5
Service	13	7.0	9.8
Other	1	0.5	1.1
Total	181	100%	100%
Source: Balachandran (2006, p. 386)			

Appendix A
Simulation of operator management fees:
Comparison of traditional management fee basis with residual income fee basis

Imagine a hotel operator is considering which of two mutually exclusive potential investment opportunities, Project A or Project B, it will promote to the owner of a hotel it manages. Project A will require an initial investment of \$1,000,000 and Project B will require an initial investment of \$4,000,000. The projected revenue and profit projections associated with the two investment alternatives are outlined below.

	Project A		Project B	
	Revenue	Gross operating profit	Revenue	Gross operating profit
Year 1	\$500,000	\$200,000	\$800,000	\$320,000
Year 2	\$500,000	\$200,000	\$800,000	\$320,000
Year 3	\$500,000	\$200,000	\$800,000	\$320,000
Year 4	\$500,000	\$200,000	\$800,000	\$320,000
Year 5	\$500,000	\$200,000	\$800,000	\$320,000

Based on a typical traditional fee incentive of 3% of gross revenue and 10% of gross operating profit, we find that the operator would prefer Project B as it would result in an increase in the operator fee revenue of \$56,000 (3% of \$800,000 + 10% of \$320,000) per annum for the five years of Project B's life. This is more than the \$35,000 (3% of \$500,000 + 10% of \$200,000) projected incremental fee revenue that would result if Project A were pursued.

On an ROI and RI basis, it can be seen than project A provides the higher return, however. Project A provides an ROI of 20% ($\$200,000 \div \$1,000,000 \times 100$) per annum and Project B provides an ROI of 8% ($\$320,000 \div \$4,000,000 \times 100$) per annum. If the hotel owner imputes a 10% required rate of return (based on its cost of capital) charge when calculating RI, we see that Project A has a positive RI of \$100,000 ($\$200,000 - (0.1 \times \$1,000,000)$) per annum and Project B has a negative RI of \$80,000 ($\$320,000 - (0.1 \times \$4,000,000)$) per annum.

If the operator were to be paid an incentive that is set at (say) 40% of RI, pursuit of Project A would result in an increase in the operator's fee revenue of \$40,000 (40% of \$100,000) per annum and pursuit of Project B would result in a decrease in the operator's fee revenue of \$32,000 (40% of -\$80,000) per annum.

A comparison of the projected ROIs for the two projects and the fact that Project B fails to satisfy the owner's 10% required rate of return provides a persuasive case that the hotel owner would prefer to take Project A. Capital expenditure goal congruency is promoted if the operator is remunerated based on RI (Project A has the higher RI), but it is not promoted if the operator is remunerated based on a revenue and profit incentive, as the operator would have an incentive to promote Project B.

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