SUMMER 2017
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THE NEWSLETTER OF THE BDO RESTAURANT PRACTICE

SELECTIONS

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INCENTIVE PROGRAMS FOR A RESTAURATEUR

By Tom Ziemba and Vince Stasiulewicz

There are a number of ways to incentivize key employees at any restaurant operation. This article covers some of the incentive vehicles and plans used by restaurateurs.

UNIQUE ISSUES FACING RESTAURATEURS

Regardless of the type of restaurant operator or segment, there are several key issues facing restaurateurs that are vital to master for effective operations and long-term success:

1. **Cash Flow:** Restaurateurs are highly focused on whether there will be enough cash flow or if there's enough growth in cash flow to support long-term plans. Whatever the case, when cash flow purveyors aren't paid, neither is payroll. Beyond payroll, cash flow issues can impact other expenditures, including real estate obligations.

2. **Prime Costs:** This is the total cost of service per guest, including labor and benefits as well as food and beverage costs. Since prime costs can total 50 percent or more of a restaurant's annual revenues, this is an area where restaurateurs can fine-tune operations to balance profitability, guest service and planned investments.

3. **Employee Retention/Turnover:** Like other industries, labor for restaurants is critical to success. However, unlike other industries, restaurants tend

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to have high employee turnover rates. For some operations, it's not uncommon to turn over half of the work force every calendar year. Thus, attracting and retaining key employees is an important element in the design of an incentive program.

4. **Gross Profit:** This is the total profit after you've subtracted the cost of goods sold (the total cost of each service per guest) from the total revenue (the total sale for each guest). For a number of restaurateurs, this determines restaurant operations for the next year.

These unique issues are also widely used performance metrics in designing incentive programs. However, it's not as simple as incorporating metrics into an incentive plan, then standing back and watching your restaurant grow. Often, performance metrics can contradict each other. For example, how much of your cash flow do you invest to stabilize employee turnover, which will increase prime costs and cut into gross profit?

It's important to bear these dynamics in mind when determining incentive programs.

SHORT-TERM INCENTIVES

Short-Term Incentives (STIs), one of the most popular plans, are incentives that are typically paid in one year or less for measured performance. They are sometimes referred to as an annual bonus. To make the most of STIs, the metrics and goals being measured are typically agreed upon before the performance period to ensure the individual is in a position to impact the outcomes. Therefore, it may make sense to use a prime cost target as a goal for your general manager, but not for an expeditor, for example.

At the end of the measured performance period, whether it be monthly, quarterly or annually, the actual performance (prime cost, in the example above) is measured against the pre-determined goal. If performance meets the goal expectations, then an incentive, usually in the form of cash, is paid out. Restaurants experiencing cash flow issues can sometimes pay this incentive in the form of equity, stock or stock options, or in another form of pseudo-equity.

For many employees that you want on an incentive plan, a short-term incentive program can go a long way in reinforcing your operation's goals. STIs are incredibly flexible and allow you to communicate what's important for your operation in the next performance period by rewarding for that goal.

For example, imagine you've set a cash flow goal for your key employees in the first 12 months of your operation. After your first year of operation, you've experienced better-than-expected performance with higher average sales per diner and more foot traffic than planned, leaving you flush with cash. As a result, this turns your attention toward weighted performance on prime costs and less on cash flow, resulting in a slightly higher target for gross profit for the next performance period. This example illustrates how STIs can make sense for quickly evolving businesses that need flexible planning options.

LONG-TERM INCENTIVES (EQUITY)

In addition to short-term incentives discussed above, there are many long-term incentives (LTIs) available for businesses to apply when attracting and retaining key talent. If you're a restaurateur who envisions using equity to share your operation's long-term growth with key employees, you're likely considering using restricted stock or stock options.

Restricted stock

Restricted stock is similar to common stock in a company, with one main difference: the employee you issue the restricted stock to can't sell until it vests. That means there is a requirement that must be met, whether it's a time-based or a performance-based requirement, before the key employee can sell or monetize the stock. If the key employee leaves before the restricted stock vests, the shares are typically forfeited and that employee does not realize any of the potential gains in value since they were granted. In addition, any expense previously recognized is reversed. Restricted stock also has very specific tax and accounting implications that not only affect your operation, but may also have consequences for those employees, if not fully understood.

Before we consider the accounting for stock granted to an employee as compensation, let's first consider how to account for a sale of stock. Imagine that ABC Corporation, a fictitious entity, decides to issue 1,000 shares of $100 cumulative nonparticipating preferred stock with a 6 percent dividend rate. Like common stock, preferred stock can be issued for more than par value. If that is the case, the additional funds are placed into an additional paid-in capital account that is **separate** from the common additional paid-in capital account. For this example, we'll say that ABC issues the shares for $105.

Account Names	Debits	Credits
Cash	105,000*	
Preferred Stock, $100 par value		100,000
Additional Paid-in Capital – Preferred Stock		5,000
(*) $105,000 = $105 x 1,000		

A cash dividend at the end of the first year is handled in a similar manner to common stock dividends. Again, you must separate preferred dividends from common dividends.

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Account Names	Debits	Credits
Preferred Dividends	6,000*	
Cash		6,000
(*) $6,000 = 1,000 shares x $6		

Note, if the dividends are not paid on cumulative preferred stock, a liability for dividends in arrears is **not reported** on the balance sheet. Instead, the company discloses the amount in financial statement notes.

Stock options

Stock options are another popular form of equity that restaurateurs apply. Stock options differ from restricted stock in that when they are initially granted, they are not considered stock but still have a dilutive cost to the company.

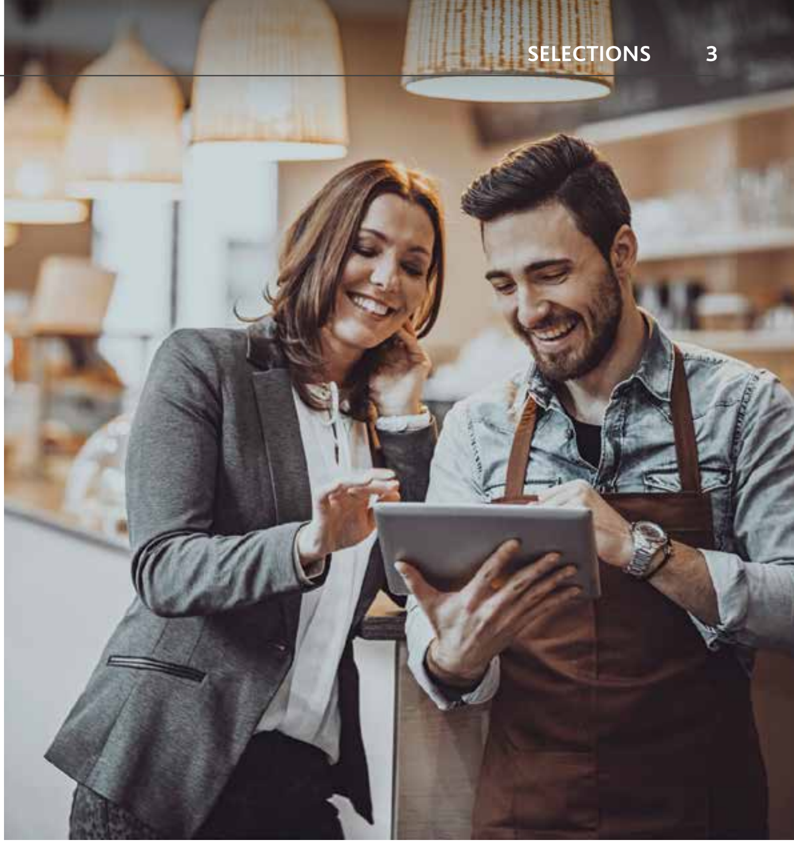
Like restricted stock, stock options have a number of tax and accounting issues that may impact both your operation and your key employees' personal tax and financial positions.

Accounting for Stock Compensation

All stock plans are assumed to be a form of compensation, which requires recognition of an expense under U.S. Generally Accepted Accounting Principles (GAAP). In the case of grants of restricted stock, the fair value of stock on the date of grant represents the amount of expense to be recognized. For stock options, the amount of the expense is the fair value of the options, but that value is not apparent from the exercise price and the market price alone. Determination of the value requires the utilization of an appropriate option pricing model (e.g. Black-Scholes model).

Assuming equity classification[1] of the restricted stock and stock options, the expense is recorded equally throughout the entire vesting period, which is the time between the date the company grants the stock or options and when the individual is allowed to exercise the option or sell the stock. In other words, U.S. GAAP considers the stock or options earned by the employee during the vesting period. The entry credit applies to a special additional paid-in capital account.

Consider a scenario where ABC Corporation grants its CEO 5,000 stock options on Jan. 1, 20X4. Each option allows the CEO to purchase one share of $1-par-value stock for $80 on Dec. 31, 20X7. The current market value of the stock is $75. The value of one stock option calculated using an option pricing model is $10. Each year, the company will record the following compensation entry:



Account Names	Debits	Credits
Compensation expense	12,500	
Additional paid-in capital – stock options		12,500

The total value of the options is $50,000 (5,000 x $10), and the vesting period is four years, so each year the company will record $12,500 of compensation expense related to the options. If the options are exercised, the additional paid-in capital built up during the vesting period is reclassified. The stock's market value is irrelevant to the entry, the credit to additional paid-in capital (common stock) is to balance the entry and is not related to market value.

Account Names	Debits	Credits
Cash	400,000	
Additional paid-in capital – stock options	50,000	
Common stock		5,000
Additional paid-in capital – common stock		445,000

If the options are not used before the expiration date, the balance in additional paid-in capital is shifted to a separate APIC account to differentiate it from stock options that are still outstanding. If the CEO leaves the company prior to the end of the vesting period, the options will be forfeited. In that case, any expense previously recognized is reversed through a credit to earnings, and the APIC account is reversed as well.

1 Stock-based compensation that can or is required to be settled in cash may result in liability classification, in which case the accounting treatment is different than that discussed above. Accounting for liability-classified employee compensation is beyond the scope of this blog.

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LONG-TERM INCENTIVES (PSEUDO-EQUITY)

Short-term incentive plans and long-term equity-based incentive plans may not be the right choice for every restaurateur. For some, granting equity via long-term incentive plans is not an option due to partner obligations, bank covenants or other restrictions. As an alternative, there are two widely used pseudo-equity incentives which allow key employees to share in the long-term growth of the business while also incentivizing them to stay: long-term cash plans and phantom stock awards.

Long-Term Cash Plans (LTCP)

LTCPs are similar to the STI plans discussed in the first installment of this series with one main difference: LTCP incentives are not paid out every year like STI plans. Instead, the value accrues in an account over the performance period (for LTCP plans, the performance period is multi-year, typically ranging from three to five years) and the value becomes payable once it vests.

Other benefits to the restaurateur are that the vesting component of this plan acts as a powerful retention tool for key employees, and the value of the plan is easily understood. An additional benefit is that the accounting is very similar to a short-term incentive plan, which is generally well understood.

Phantom Stock

Phantom stock is another type of pseudo-equity incentive. This is the closest option to granting a restricted share to a key employee. Under a typical phantom stock arrangement, an employee is granted a right to receive a cash payment at the end of a defined term equal to the value of a share of stock at the end of the term. Another common structure allows the employee to receive a cash payment equal to the appreciation in the value of a share of stock during the term, which is often also called a stock appreciation right (SAR). To the employee, it will look and act like stock, but a phantom stock award does not carry voting or dividend rights because it does not represent an actual equity instrument. The employee will, however, be able to realize the value of the stock because phantom stock can mimic the fluctuations of restricted stock without diluting the restaurateur's ownership interest. Additionally, phantom stock has tax and accounting implications that are different from restricted stock, which can have an impact on both the restaurateur and the employee.

It's important to note that the company must record a compensation charge on its income statement as the employee's interest in the award vests, and as the value of the award increases. Similar to accounting for grants of restricted stock or stock options, from the time the grant is made until the award is paid out, the company must record the value of the promised shares as they vest, pro-rated over the term of the award. However, unlike awards which are paid in shares of stock, for phantom stock awards, each year the value is also adjusted to reflect any adjustments to value arising from the rise or fall in share price, which may require a valuation to be performed if the company doesn't have an easily determinable stock price.

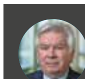
In some cases, phantom stock awards may contain performance conditions as well as service conditions. For example, a phantom stock award may vest upon three years' service plus achieving a profit target. Unlike accounting for awards with only time-based vesting conditions, for phantom stock and SARs that include performance conditions, increases are recognized as they become probable. For example, when the vesting is triggered by a performance event, such as a profit target. In this case, the company must estimate the expected amount earned based on progress toward the target. The accounting treatment is more complicated if the vesting occurs gradually because each tranche of vested awards should be treated as separate. Appreciation is allocated to each award pro rata to the time over which it is earned.

If SARs or phantom stock awards are settled in shares, however, their accounting is slightly different. The company must use a formula to estimate the present value of the award at grant.

CHOOSING THE RIGHT PLAN

There is a wide array of incentives restaurateurs are using today to attract, retain and incentivize key employees. Deciding which type of incentive is right for your business may be difficult. It may help to consider the following questions when thinking about incentives that may work best for your business:

- What will your operation look like three to five years from now?
- What will you focus on each year to reach that goal?
- How will you define your philosophy to reward incremental (annual) achievements, long-term achievements or both?
- Are you willing to grant ownership in your business to your key employees?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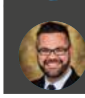
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TIPS FOR INTEGRATING THIRD-PARTY DELIVERY

By Dana Zukofsky

It wasn't that long ago that the only meal someone could get delivered came from the local Chinese restaurant or in a pizza box.

But now, with all the delivery services at our fingertips, there is no food item that can't be delivered to your home. This is a convenience that consumers cherish and have come to expect. For the restaurant owner, on the other hand, this reality presents a whole host of challenges.

FOOD QUALITY CONTROL

When customers dine at restaurants, they are expecting a certain quality of food—and they anticipate the same level of quality when it comes to delivery. Unfortunately, this is not guaranteed. Food does not always travel well and its taste may not be preserved long after it's prepared. To help minimize quality discrepancies between in-store and at-home dining, consider the following:

- Ensure delivery packaging allows the food to breathe
- Minimize menu items available to be ordered to-go
- Set restrictions on delivery radiuses

RECONCILING THE DEPOSITS FROM MULTIPLE VENDORS

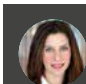
Weekly or monthly bank reconciliations from multiple credit card, gift card and house accounts should be a familiar and relatively straightforward task for bookkeepers. However, adding delivery services to the mix can disrupt and complicate the system because each delivery service—whether it's UberEats, Door Dash, Caviar, etc.—serves as its own revenue stream and has its own set of terms.

For example, each company pays differently—some daily, others monthly. Each takes fees in its own way. Some prefer to charge at the end of a period, others charge transaction by transaction. A best practice for keeping the reconciliations simple is to set up a separate tender on your business' POS systems for each delivery service. Once you receive those payments, they can be traced seamlessly to the vendor they came from.

UNAUTHORIZED DELIVERY COMPANIES

It is hard enough to control the quality of the food when you prepare it for delivery and send it off with a service you know and authorize. It gets even harder when a restaurant is faced with a service that picks up and delivers food to customers without its consent. Some food delivery companies will set up a website with a restaurant name, logo and menu, and offer delivery. Then, once a delivery order is placed, the imposter company will pick it up and deliver to the customer. This may not immediately sound problematic, but it can become a burden if something goes wrong.

It is difficult to explain to an unhappy customer that your restaurant doesn't deliver when they just received a delivery from "you." How can this be handled? After speaking to clients and industry colleagues, the consensus is that restaurateurs should aim to make the customer happy regardless. Most often, this entails offering a discount or free meal on the next visit. Some companies try to file cease and desist claims, but the food delivery companies can take the link down and replace it later. One suggested approach to combat these companies is to reach out to them and see if there is a way to work together.



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TOPIC 606, REVENUE FROM CONTRACTS WITH CUSTOMERS, A VIEW FROM THE KITCHEN

By Angela Newell

The new revenue recognition standard becomes effective on Jan. 1, 2018, for public companies. Private companies can choose to adopt the new model early, but have an additional year to comply. With the clock ticking until implementation, are you ready?

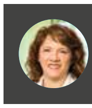
On May 28, 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (ASC 606), which provided new guidance for recognizing revenue for contracts with customers. The standard is poised to change the way franchisors recognize their revenue.

Under current revenue guidance, a franchisor would recognize the revenue from the initial franchise fee upon evidence of completion of all initial obligations (training, site selection, etc.). Generally, the opening of the store was the best indication that these obligations had been satisfied. The royalty, of course, is recognized, as the restaurant's sales took place over the period of the restaurant's operation.

However, ASC 606 indicates that the franchise right is a distinct performance obligation that transfers over time and, therefore, any portion of the initial franchise fee that is allocated to the franchise right should be recognized over the course of the contract term. This conclusion results from the fact that the franchise license derives its value from the past and ongoing activities of the franchisor, such as branding and marketing activities. The royalty, of course, is recognized as the restaurant operates and the sales occur.

In most cases, the upfront franchise fee—and, by extension, any area development fees—will now generally be recognized over the term of the franchise license. However, the new standard retains the requirement to defer any broker fees paid in relation to entering into the franchise license, and requires them to be amortized generally over the same period.

For a more in-depth discussion of the new standard and the varying impacts on franchisors, franchisees and owner/operators, please see our newsletter, **BDO Knows FASB: Topic 606, Revenue from Contracts with Customers, A View from the Kitchen**.



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