

New Trends and Practical Tips for Dealing with Forfeitures Under FAS 123(R)

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Agenda

- **Expensing – a brief history**
- **Forfeiture rate analysis – different perspectives**
- **Current climate – What companies are doing**
- **Future trends in forfeiture analysis**
- **Forfeiture application and true up – Past and Present**
- **Two Common Methodologies – Advantages and Disadvantages**
- **Final thoughts**

Reminder: Always Consult Advisors

- **This presentation is a high-level overview of the features described**
- **It is not intended to be and should not be relied on as specific tax, accounting or legal advice**
- **Your company's specifics may involve circumstances that cause the laws, rules, regulations, standards and principles described to apply differently**

A Brief History of expensing and forfeitures

APB 25

- **Expense recognition rare**
 - **Discounted**
 - **Variable**
- **No need for forfeiture analysis**
 - **True up on date of forfeiture**

A Brief History of expensing and forfeitures

FAS 123

- Required valuation of employee stock options
- Either forfeiture rate reduction OR true up actual forfeitures as they occur, not both
- Most companies trued up on forfeiture date/ no need for forfeiture analysis
- “Only a footnote”

A Brief History of expensing and forfeitures

FIN 44

- More “traps” for expense recognition
- Repricings, changes in status, substantive modifications
- Made expensing less comfortable
- still no forfeitures

A Brief History of expensing and forfeitures

FAS 123R

- **Expense recognition/fair values**
- **Reduce or “haircut” expense by an estimated forfeiture rate**
- **True up the estimated rate to actual experience**
- **Forfeiture analysis is here to stay**

Forfeiture analysis – in the beginning

- **Scrutiny high on methodology and results**
- **Do you consider the “boom” and “bust” periods?**
- **What formula do you use? Not much consensus**
- **Forfeiture vs. vested cancellation – compare against shares granted, outstanding, unvested**
- **Will the estimate match actual behavior?**

Forfeiture approach – in the beginning

- **Consultative approach may differ for each company**
- **Factors include the company's history, participant makeup, Industry**
- **No consensus on approach from consultants, vendors, accounting professionals**
- **Companies delved into forfeiture data to choose their own approach**

Current Climate – what companies are doing

- **Combination of historical and forecasted data**
- **The “mix” of history vs. forecasting may differ from company to company**
- **Segmentation by participant group**
- **Insider vs. rank-and-file, International vs. domestic, Restricted Stock vs. options**
- **Administrator movement – may see varied approaches**

Current Climate – what companies are doing

- **Revisiting their numbers quarterly or monthly**
- **Initial analysis based on history - no way of knowing how close it would be to actual experience**
- **Ease of getting to data critical for constant analysis**

Current Climate – what companies are doing

- **Methodology should be easily repeatable and auditable**
- **Expertise is still needed (internal or external) to explain rate calculations**
- **Still a variety of forfeiture calculations, still need to prove calculations to auditors**

Emerging trends in Forfeiture analysis

- **Combine volatility projections with forfeiture analysis**
- **As stock price fluctuates, forfeitures may occur at higher or lower rates**
- **More detailed analysis on seasons and events**
 - **forfeiture after bonus payout**
- **Forfeiture fluctuations based on hiring/firing patterns, seasonal slowdowns, etc.**

Emerging trends in Forfeiture analysis

- **Increased demand from upper management on forecasting future forfeiture trends**
- **Results affect the bottom line**
- **better tools to make forecasting easier and more accurate**
- **Forecast tools and forecast data will have to back up those projections**

Emerging trends in Forfeiture analysis

■ Analysis by “In-the-moneyness” level

		Annualized Probability of Forfeiture												
S/K Ratio		24	22	20	18	16	14	12	10	8	6	4	2	0
		250%+	N/A	0.9%	0.9%	0.8%	0.8%	0.8%	0.8%	0.8%	0.7%	0.7%	0.7%	0.7%
240%	N/A	1.1%	1.1%	1.1%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	0.9%	0.9%	0.0%	
220%	N/A	3.0%	3.0%	2.9%	2.8%	2.8%	2.7%	2.6%	2.5%	2.5%	2.4%	2.4%	0.0%	
200%	N/A	4.9%	4.8%	4.8%	4.7%	4.7%	4.6%	4.6%	4.5%	4.4%	4.2%	4.2%	0.0%	
180%	N/A	6.1%	6.1%	6.0%	5.9%	5.9%	5.7%	5.6%	5.4%	5.3%	5.1%	5.0%	0.0%	
160%	N/A	7.2%	7.0%	6.9%	6.7%	6.7%	6.5%	6.4%	6.2%	6.1%	6.0%	5.8%	0.0%	
140%	N/A	8.8%	8.6%	8.3%	8.1%	7.9%	7.8%	7.7%	7.7%	7.7%	7.6%	7.5%	0.0%	
120%	N/A	9.6%	9.6%	9.5%	9.2%	9.2%	8.9%	8.7%	8.4%	8.4%	8.1%	8.0%	0.0%	
100%	12.0%	10.9%	10.7%	10.7%	10.6%	10.4%	10.3%	10.0%	9.8%	9.6%	9.5%	9.2%	0.0%	
90%	N/A	12.2%	12.1%	11.8%	11.6%	11.3%	11.1%	11.0%	10.9%	10.6%	10.5%	10.3%	0.0%	
80%	N/A	18.0%	17.9%	17.8%	17.7%	17.6%	17.5%	16.9%	16.9%	16.5%	15.9%	15.3%	0.0%	
70%	N/A	22.9%	22.3%	22.0%	21.7%	21.3%	21.3%	20.9%	20.1%	19.4%	19.0%	18.8%	0.0%	
60%	N/A	35.7%	34.7%	34.7%	33.5%	32.9%	32.8%	32.5%	31.8%	31.1%	30.0%	29.6%	0.0%	
50%	N/A	46.5%	46.2%	46.1%	45.1%	43.5%	43.4%	43.0%	41.6%	41.3%	40.2%	39.3%	0.0%	
40%	N/A	52.7%	52.7%	51.7%	51.5%	51.3%	49.8%	49.4%	48.0%	46.3%	45.1%	43.4%	0.0%	
30%	N/A	61.3%	61.2%	59.3%	57.1%	56.0%	54.8%	53.3%	52.2%	50.6%	50.2%	49.9%	0.0%	
20%	N/A	68.7%	66.4%	64.7%	62.8%	62.5%	61.8%	59.9%	58.1%	56.1%	54.7%	52.6%	0.0%	
10%	N/A	79.0%	78.6%	76.5%	74.5%	73.0%	70.7%	70.3%	68.6%	67.7%	65.4%	63.3%	0.0%	

Emerging trends in Forfeiture analysis

- **Analysis by “In-the-moneyness” level**
 - **The table on the prior is based upon a company that has seen historical forfeiture rates of 12.0% annually**
 - **Current forfeiture rate selected based on “in-the-moneyness” (S/K Ratio) of award, which averages to 180%**
 - **Therefore, actually use a weighted average forfeiture rate of 5.32%**
 - **Takes into account all known subsequent information**

Emerging trends in Forfeiture analysis

■ Analysis by Seasonality

Company	Granted Options	Forfeited Options	Annualized Forfeiture %	Annualized % - Q1	Annualized % - Q2	Annualized % - Q3	Annualized % - Q4
Company 1	4,799,808	567,921	5.93%	5.64%	7.27%	5.27%	3.45%
Company 2	44,090,523	17,325,171	16.14%	4.99%	8.61%	22.41%	7.65%
Company 3	139,012,058	37,016,350	13.94%	5.66%	5.06%	24.78%	6.00%
Company 4	196,479,697	39,080,223	10.23%	9.98%	9.01%	9.86%	8.26%
Company 5	34,173,737	6,772,099	8.00%	7.45%	5.78%	7.20%	8.56%
Company 6	194,255,881	63,205,508	16.51%	6.27%	5.85%	23.33%	12.96%
Company 7	198,462,699	51,465,711	15.03%	12.28%	12.41%	14.76%	9.79%
Company 8	147,738,279	6,926,511	2.46%	2.57%	2.75%	2.33%	1.87%
Company 9	8,521,633	928,381	5.68%	1.89%	4.16%	7.21%	7.35%
Company 10	15,016,492	4,849,763	19.08%	12.08%	14.17%	15.88%	14.92%
Company 11	22,335,380	5,025,034	5.25%	8.80%	3.88%	3.67%	2.72%
Company 12	14,312,806	1,037,664	3.91%	3.81%	5.12%	3.62%	2.45%
Company 13	18,731,600	815,759	2.71%	3.01%	1.65%	1.62%	4.26%
Company 14	43,017,534	9,810,579	9.44%	5.54%	6.00%	14.56%	6.43%
Company 15	104,004,946	19,872,583	7.01%	5.29%	4.60%	4.64%	11.03%
Company 16	8,365,653	589,540	3.83%	2.12%	2.86%	8.14%	1.45%
Company 17	40,074,002	6,525,484	9.09%	6.20%	10.57%	8.46%	8.38%
Company 18	65,336,337	11,493,383	8.98%	5.03%	10.51%	8.86%	8.10%
Company 19	8,084,695	1,289,736	7.89%	6.30%	6.55%	7.97%	8.03%
Company 20	261,396,185	53,883,661	8.31%	6.86%	8.35%	8.10%	6.85%
Company 21	708,426,003	99,450,004	5.14%	4.80%	4.18%	5.46%	4.68%
Company 22	55,524,938	12,554,086	11.28%	8.07%	12.25%	10.74%	8.02%
TOTAL	2,332,160,886	450,485,151	8.47%	6.51%	6.65%	10.60%	7.21%

Emerging trends in Forfeiture analysis

▪ Analysis by Seasonality

- The 22 companies on the prior page illustrate significantly more termination experience in the 3rd quarter
- Over 50% of companies had significantly more forfeiture in one quarter of the year
- Application of seasonal rate takes into account all known subsequent information

Expense Application and True up

- **123R - very vague on methodology**
- **Not much guidance in the early days from which to draw conclusive application**
- **The guidance that did exist “evolved” every 3-6 months**
- **Reporting companies, vendors and auditors made ad hoc adjustments to their previous conclusions**

Expensing – Early days of 123R

- **FASB guidance on forfeiture application was vague**
- **Only guidance was to “periodically” true up**
- **Public companies, vendors and auditors looked to FASB for more specific guidance and examples**
- **Accounting firms provided more specific examples of the haircut and true up, which helped**

Expensing - Present

Expense methodology should have some common traits:

- **Treat company grants as a pool of grants when applying the estimated forfeiture rate**
- **Follow GAAP principles when applying the forfeiture rate and truing up to actual experience**
- **Comply with the rules of FAS 123(R) for forfeiture “haircut” and true up**

Expensing - Present

- **Expense reduction should take into account the vest tranche to the extent that shares vests after FAS 123R adoption (Modified Prospective)**
- **Periodic true up to actual forfeitures may mean true up based on reporting period or vest schedule**
- **Two common methods: “True up on Vest” and “Shortened Service Period” approaches**

True up on Vest Date

▪ Example:

- 5 grants of 100 shares each granted on 1/1/06, cliff vest in 1 yr
- Fair Value per Share = \$1, Total Fair Value = \$500
- Straight-line accrual approach selected
- Historic annualized “turnover rate” (“forfeiture rate”) = 20%

_____	\$100
_____	\$100
_____	\$100
_____	\$100
_____	\$100
	=\$500
	* 80%
	=\$400

True up on Vest Date

- **First quarter of accrual:**

- **No grants forfeited, no adjustments made, since company still expects 20% over 1 year of vesting**

- **Accrual: $\frac{1}{4}$ vesting complete = $.25 * \$500 = \125**

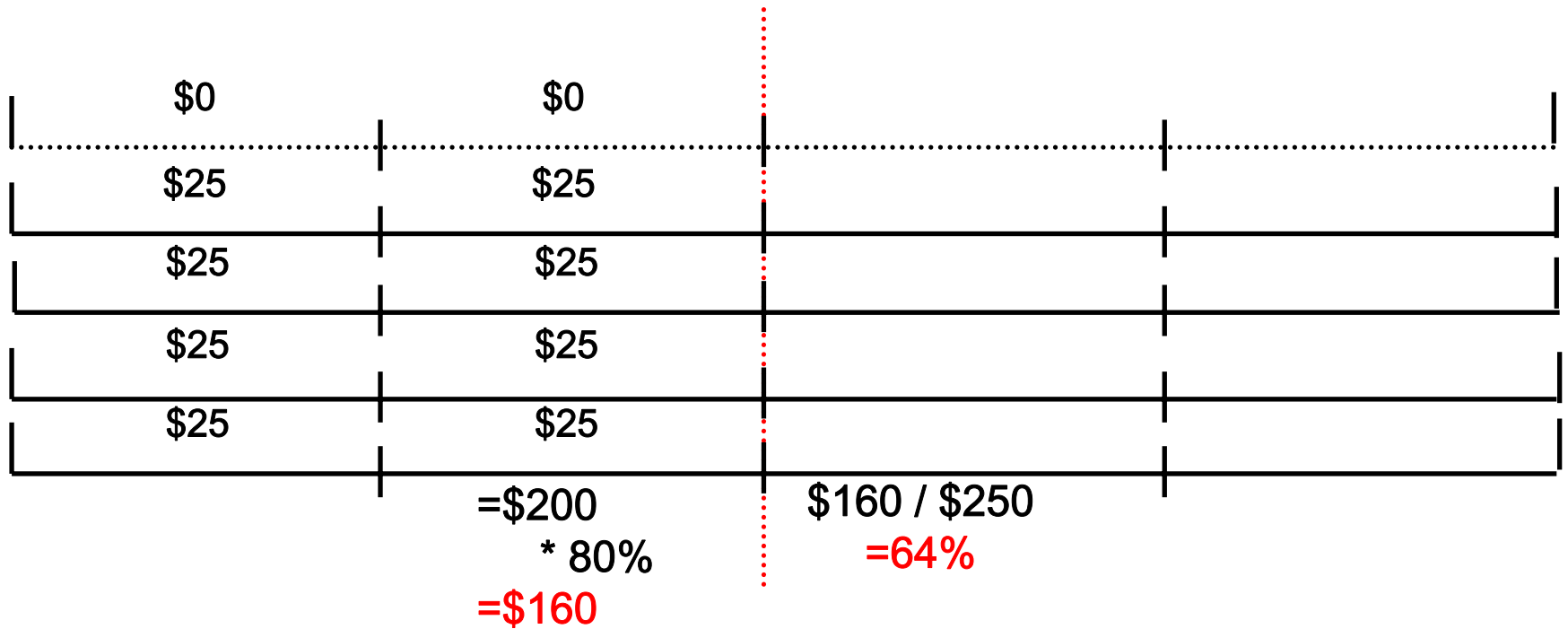
- **Reduction done on group level: $\$125 * 80\% = \100**

\$25			
\$25			
\$25			
\$25			
\$25			
= \$125			
* 80%			
= \$100			

True up on Vest Date

- **One of the grants was forfeited:**
 - **Why do all the grants still appear on the report?**
 - **Why don't you reverse the expense accrued for the forfeited grant?**
- **Because**
 - **A) no expense has been accrued for the grant (because of the “haircut”) and**
 - **B) if the grant were removed from the report, the total expense would be reduced AND the forfeiture rate applied = double counts the forfeiture**

True up on Vest Date



True up on Vest Date

- **Third quarter of accrual:**
 - **Reduction in force required: 2 of grants forfeited**
 - **New “expected to vest” % is 60%**
 - **Accrual: $\frac{3}{4}$ vesting complete = $.75 * \$500 = \375**
 - **To Date expense: $\$375 * 60\% = \225**

\$25	\$25	\$25	
\$25	\$25	\$25	
\$25	\$25	\$25	
\$25	\$25	\$25	
\$25	\$25	\$25	
\$25	\$25	\$25	
	= \$250	= \$375	
	* 80%	* 60%	
	= \$200	= \$225	

True up on Vest Date

- Forth quarter of accrual:
 - “Expected to vest” % is still 60%
 - Accrual: All vesting complete = $1 * \$500 = \500
 - Now known how many shares vested vs. forfeiture

				<u>Expense</u>
				<u>Retained</u>
\$25	\$25	\$25	\$25	\$0
\$25	\$25	\$25	\$25	\$0
\$25	\$25	\$25	\$25	\$100
\$25	\$25	\$25	\$25	\$100
\$25	\$25	\$25	\$25	\$100
		=\$375	=\$500	=\$300
		* 60%	* 100%	
		=\$225	=\$500	

Accrual: Shortened Service Period

- Using the same example:
 - No grants forfeited, no adjustments made, since company still expects 20% over 1 year of vesting
 - Accrual: $\frac{1}{4}$ vesting complete = $.25 * \$500 = \125
 - Reduction done on group level: $\$125 * .8^{.75} = \105.74
- | | | | |
|-----------|--|--|--|
| \$25 | | | |
| \$25 | | | |
| \$25 | | | |
| \$25 | | | |
| \$25 | | | |
| =\$125 * | | | |
| 84.597% | | | |
| =\$105.74 | | | |

Accrual: Shortened Service Period

- **Why are we using a service period of .75 to apply the 20% forfeiture rate?**
- **Rationale: Time elapsed (first quarter) is no longer relevant for “expected to vest” estimate**
- **Service period 1 - .25 time elapsed = .75 remaining service period**
- **By Reducing the service period over time, this technique allows you to true up on the date of forfeiture**

Accrual: Shortened Service Period

- **Second quarter of accrual:**
 - 1 grant forfeited. since company still expects 20% over 1 year of vesting, rate doesn't change.
 - **Accrual: $\frac{1}{2}$ vesting complete = $.5 * \$400 = \200**
 - **Reduction done on group level: $\$200 * .8^{.5} = \178.88**

\$25	\$25		
\$25	\$25		
\$25	\$25		
\$25	\$25		
\$25	\$25		
		= \$200 *	
		* .8944	
		= \$178.88	

Accrual: Shortened Service Period

- Third quarter of accrual:
 - Reduction in force required: 2 of grants forfeited
 - New “expected to vest” % is 60%
 - Accrual: $\frac{3}{4}$ vesting complete = $.75 * \$300 = \225
 - To Date expense: $\$225 * .6^{.25} = \198.025

\$25	\$25	\$25	⋮
\$25	\$25	\$25	
\$25	\$25	\$0	
\$25	\$25	\$25	
\$25	\$25	\$25	
	= \$200 *	= \$225 *	
	* .8944	* .88012	
	= \$178.88	= \$198.25	

Accrual: Estimation of Forfeitures

- Forth quarter of accrual:
 - “Expected to vest” % is still 60%
 - Accrual: All vesting complete = $1 * \$500 = \500
 - Now known how many shares vested vs. forfeiture

					<u>Expense</u> <u>Retained</u>
\$25	\$25	\$25	\$25		\$100
\$25	\$25	\$25	\$25		\$100
\$25	\$25	\$0	\$0		\$0
\$25	\$25	\$25	\$0		\$0
\$25	\$25	\$25	\$25		\$100
			$=\$225 *$	$=\$300$	$=\$300$
			$* .88012$	$* 100\%$	
			$=\$198.25$	$=\$300$	

Comparing the two methods period by period

“True up at Vest” Approach:

	Q1	Q2	Q3	Q4	
Accrued	\$97.50	\$99.80	\$26.25	\$276.45	\$500.00
Reversed					\$200
Total					\$300.00

“Shortened Service Period” Approach:

Accrued	\$105.74	\$73.15	\$19.14	\$101.97	\$300.00
Reversed					\$0
Total					\$300.00

Advantages and disadvantages

- **True up on Vest Date – advantages**
 - **Complies with FAS 123R**
 - **True to published examples from FASB and accounting firms**
 - **Follows GAAP principles**
 - **Allows consistent methodology as long as grants are treated as a pool**

Advantages and Disadvantages

- **True up on Vest Date – disadvantages**
 - **Non-pool behavior/exceptions still trued up on vest date**
 - **RIF's, spin-offs, executive or large grant forfeitures**
 - **Requires that grant pool be kept intact through final vest date – forfeited grants remain in pool**

Advantages and Disadvantages

- **“Shortened service period” approach Advantages:**
 - **Follows GAAP Principles**
 - **Pool exceptions dealt with on date of forfeiture**
 - **More frequent true up to actual if vesting is annual or longer**
 - **True up on forfeiture date intuitive**

Advantages and Disadvantages

- **“Shortened Service Period” approach disadvantages**
 - **Contradicts the letter of paragraph 74**
 - **No examples of methodology from FASB or any of the “Big 4” Accounting firms**
 - **May under accrue for some periods (Para. 42)**

Advantages and Disadvantages

- **Regardless of methodology, auditors need to be comfortable with methodology and results**
- **Both methodologies work, as long as they follow GAAP, adhere to the rules of 123R, and treat the participant grants as a pool when applying the forfeiture rate and truing up to actual results**
- **Over time, both techniques yield similar results**

Advantages and Disadvantages

- **Both methods will continue to be used**
- **Both methods will continue to require work to get auditors to a “level of comfort” with the technique used as well as the result**
- **Facts and circumstances of each reporting company may determine preferred methodology**

Final Thoughts

- **Alternate Methods of applying estimate/truing up to actual**
- **Work with accounting professionals and auditors**
- **No one methodology is perfect, or approved by FASB or the Big 4 firms**
- **Make sure your methodology complies with FAS 123R and conforms to GAAP**
- **Expense methodology should reflect company behavior**