Best-in-class accruals management

Planning for assignment costs related to stock awards

27-30 October 2013
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Agenda

► Importance of accruals
► Best-in-class accruals process
► Ownership of process
► Accrual techniques
► Accrual true-up
► Accrual adjustments
► Managing big surprises
► Driving a successful accruals process
► Real-life example – Starbucks
► Summary
Definition of accruals

Accruals are accounts on a balance sheet that represent liabilities and non-cash-based assets used in accrual-based accounting. These accounts include, among many others, accounts payable, accounts receivable, goodwill, future tax liability and future interest expense.

The use of accrual accounts has greatly increased the amount of information on accounting statements. Before the use of accruals, only cash transactions were recorded on these statements. But cash transactions don’t give information about other important business activities, such as revenue based on credit and future liabilities. By using accruals, a company can measure what it owes looking forward and what cash revenue it expects to receive.
Importance of accruals

- Better cost management and budgeting
- Stakeholders can anticipate cost associated with international assignments
- Financial statements more accurately reflect the company’s liabilities
- Improved relevancy of cost projections:
  - Timely adjustments based on key changes
- Reduce unexpected charges to business units
Survey question
Company accruals

How many companies here are preparing cost estimates at the beginning of the assignment?

Are these shared with finance?
Best-in-class accruals process

- Drive and maintain tax accruals centrally
- Calculate tax costs using an agreed accrual technique
- Spread tax cost evenly over assignment length
- True-up annually after completion of tax returns and tax equalization settlements (TEQs)
- Adjust tax costs as needed
Drive and maintain tax accruals centrally

- Centralizing the accrual process helps to:
  - Ensure consistent approach to accruals
  - Avoid clearing of accruals too soon or not clearing timely
  - Allow for management of new assignment accruals on a streamlined basis

- Critical to identify key stakeholders:
  - Mobility team
  - Tax
  - Finance
  - Accounting
  - Corporate controllers (cost center management)
## Tax accrual stakeholder examples

<table>
<thead>
<tr>
<th>Task</th>
<th>Responsible party</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gather compensation information – 2014</td>
<td>HR, business units for assumptions on base, bonuses; stock/executive compensation</td>
</tr>
<tr>
<td>Prepare cost projection for 2014 and provide to business units</td>
<td>Tax provider, tax function</td>
</tr>
<tr>
<td>Book accruals – 2014</td>
<td>Business units – finance</td>
</tr>
<tr>
<td>Update cost projection for 2014 as appropriate (quarterly or annually)</td>
<td>Tax provider, HR</td>
</tr>
<tr>
<td>Make tax payments – 2014 and future years</td>
<td>Company host entities per tax provider’s instructions</td>
</tr>
<tr>
<td>Reverse accruals</td>
<td>Business units – finance</td>
</tr>
<tr>
<td>True-up of accruals at year-end</td>
<td>Business units – finance</td>
</tr>
</tbody>
</table>

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**Drive and maintain tax accruals centrally**

- Calculate tax costs using agreed accrual technique
- Spread tax cost evenly over assignment length
- True-up annually after completion of tax returns and TEQs
- Adjust tax costs as needed

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Best-in-class accruals management
Accrual techniques

Global:
- Determine percentage relationship between total tax reimbursements and total expatriate compensation for past few years and apply this percentage to current year compensation
- Assumes stable demographics

Country:
- Same as global except uses the tax reimbursement and total compensation amounts by country
- More accurate than global modeling when population shifts
Accrual techniques

Stratified model:
► Make projection at various compensation levels (i.e., low, medium and high compensation)
► Multiply by number of individuals at that level
► Useful if there is a large population in single country

Individual:
► Upfront projection of tax reimbursement by year
► Annual update of projection
► Alternative models available
Spread tax cost evenly over assignment length

- Finance organization is better able to manage corporate budgets for international assignments
  - Avoid surprises to associated stakeholders

- Financial statement impact:
  - Account for costs in proper period
  - Accrue for future payments in the year service is rendered
  - Management issue – recognition of future costs:
    - Actual book accruals

- Drive and maintain tax accruals centrally
- Calculate tax costs using agreed accrual techniques
- Spread costs evenly over assignment length
- True-up annually after completion of tax returns and TEQs
- Adjust tax costs as needed
Annual accrual process

Gather global compensation information

Prepare cost projection and provide to business unit

Update cost projection as appropriate (quarterly, annually, key changes)

Make tax payments

Reverse accruals

Drive and maintain tax accruals centrally

Calculate tax costs using agreed accrual techniques

Spread costs evenly over assignment length

True-up annually after completion of tax returns and TEQs

Adjust tax costs as needed
Key factors in accrual adjustments

Assignee population:
► Material compensation increase
► Changes in distribution
► Additional countries
► New assignees
► Program size

Tax authorities:
► Rate changes
► Regulatory changes
► Treatment of stock plans
► Treatment of allowances

Assignments:
► Extended assignments
► Early ending assignments

Exchange rates:
► Changes can impact valuation

Mobility policy:
► New allowances
► Increase/decrease to allowances
► TEQ policy changes

Family events:
► Increase/decrease in family size
► Marriages

Pensions and benefits:
► Country variations
► Changes to benefits packages

Tax year closes:
► Tax year ends represent opportunity to reevaluate outstanding accruals depending on adopted methodology

Drive and maintain tax accruals centrally
Calculate tax costs using agreed accrual techniques
Spread costs evenly over assignment length
True-up annually after completion of tax returns and TEQs
Adjust tax costs as needed
Survey question
Accrual adjustments

For those of you that have implemented accruals, how have your business units reacted to this process and fluctuations to the accrual?
Key factors in accrual adjustments
Managing big surprises

► Long-term incentive compensation:
  ► Stock grants:
    ► Adjusting accruals with every new stock award grant
    ► Time accruals to match vesting periods
  ► Stock price:
    ► Tax costs on stock are generally accrued at the top marginal rate, so swings in stock price can have a big impact
  ► Bonuses, raises, etc.:
    ► Account for large, one-time, variable, annual adjustments to compensation packages
Managing big surprises
The missed opportunity

- Long-term incentive compensation (e.g., stock options, restricted stock units) can be a significant part of an international assignee’s total compensation, especially in the case of executives.
- Not including long-term incentive compensation in cost projections can lead to large surprises.
## Example: impact of stock price swing

<table>
<thead>
<tr>
<th></th>
<th>Assignee options @ $40.00 strike price</th>
<th>Assignee options @ $50.00 strike price</th>
<th>Amount to accrue @ $40.00 strike price Grant 1</th>
<th>Amount to accrue @ $50.00 strike price Grant 2</th>
<th>Total comp to accrue Both grants</th>
<th>Total tax liability to accrue Both grants (15% tax differential)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current stock price: $45.00</td>
<td>10,000</td>
<td>20,000</td>
<td>$50,000</td>
<td>$0 (underwater)</td>
<td>$50,000</td>
<td>$7,500</td>
</tr>
<tr>
<td>What if it moves to: $55.00</td>
<td>10,000</td>
<td>20,000</td>
<td>$150,000</td>
<td>$100,000</td>
<td>$250,000</td>
<td>$37,500</td>
</tr>
<tr>
<td>What if it moves to: $30.00</td>
<td>10,000</td>
<td>20,000</td>
<td>$0 (underwater)</td>
<td>$0 (underwater)</td>
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<td>$0.00</td>
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</table>
For those of you that have implemented accruals, are you accruing for stock and other long-term incentive compensation? Bonus only? Bonus and equity?
Driving a successful accruals approach

Initial cost estimate for FY14: $2,000,000

RSU grant resulting in additional tax costs of $300,000 included in initial cost estimate

Host income tax rate decreases from 42% to 38% resulting in reduced tax cost

Additional tax cost net included in initial cost estimate:

Compensation cost of $300,000 included in initial cost estimate

Additional tax cost not included in initial cost estimate:

Total assignment cost for FY14: $3,330,000

Key Factors:
- Assignment initiation cost estimate
- RSU vest and additional RSU grant
- Bonus payout
- Host tax rate change
- Stock option exercise
- Base salary increase
- Home tax rate changes
- Ongoing/post-assignment

Key Decisions:
- Who owns/drove the cost estimate process?
- Are tax cost estimates completed for all assignments?
- Should known stock awards be included?
- If so, what is the methodology?

Stakeholders:

*Restricted stock unit (RSU)

*Slide courtesy of Starbucks*
Starbucks
Redefining the approach to accruals
Process owners – tax cost projections are prepared by EY using information provided by Starbucks Mobility. Starbucks Mobility owns responsibility for providing tax cost projection accruals to Starbucks Accounting.

Timing – cost projections are prepared at the onset of an assignment. Generally, no accrual adjustment process is in place based on accrual balances, but done on a case-by-case basis based on changes to partner/assignment.

Accruals are charged out monthly based on the projected length of the assignment.
Process/cash flow – The tax accrual is set up in the home country and used to carry the timing differences between the expense and actual tax liability paid. An example of cash flow for an equity transaction is as follows:

Award value of: $1,000,000
Hypothetical taxes of $400,000 retained from Partner
US FTC claimed as applicable *
Germany FTC claimed as applicable *

October 2009 RSU Grant
October 2012 RSU Vest
US Tax Return Filed April 2013
Germany Tax Return Filed January 2014

Tax remittance to the tax authorities:
US: $250,000
Germany: $275,000

Total cash flow:
Taxes paid: $525,000
Hypo retained: $400,000
Total Tax Cost to Company: $125,000

* No additional cost impact to Company at the time of filing the returns as the amounts remitted at the taxable event match the Partner’s final tax liability (i.e. hypothetical withholding rate and withholding rate are equal).

Slide courtesy of Starbucks
Current state
Accrual process

► Current cost projection calculations do not include stock compensation, regardless if it is known at time of assignment initiation.

► Host market currently bears all assignment-related costs:
  ▶ There have been “surprises” for the stock compensation costs that are hitting the business/local markets, both during assignment and after (trailing liabilities).
  ▶ These costs relate to stock compensation and related taxes funded by Starbucks.
  ▶ Corporate tax policy regarding which entities bears stock compensation costs may not align with mobility cost bearing policy.
Challenges
Accrual process

- Initial accruals do not comprehensively reflect the projected costs of the assignment
  - Outstanding stock awards not considered in initial cost estimate
- Accruals are not adjusted during the year for many factors that impact cost
  - If accruals are not adjusted during the year, the company expenses per the financial statements may be overstated or understated (fixed when accruals are cleared)
- Accrual liabilities are not cleared as part of a standard process
- Inconsistent methodology for trailing tax liability compliance
Where to go from here?
## Stock and policy

### Key questions

<table>
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<th>Functional owner(s)</th>
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<th>Potential impact</th>
<th>Notes</th>
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<tbody>
<tr>
<td>Compensation</td>
<td>Should all assignment-related stock compensation be covered under policy (e.g., no cap)?</td>
<td></td>
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<tr>
<td>Corporate Tax, Stock</td>
<td>How long do assignees stay under the policy due to trailing stock liabilities?</td>
<td></td>
<td></td>
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<tr>
<td>Corporate Tax, Finance</td>
<td>Do host markets bear costs of stock compensation?</td>
<td></td>
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<td>Corporate Tax, Finance</td>
<td>If yes, how is stock compensation sourced from a cost-bearing perspective?</td>
<td></td>
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<tr>
<td>Corporate Tax, Finance</td>
<td>Which entity bears costs incurred post-assignment?</td>
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<td>Stock, Accounting</td>
<td>Are taxable events post-assignment subject to hypothetical tax?</td>
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# Accrual process

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<td>Should known stock awards be included in cost projections?</td>
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<td>If yes, what assumptions are made around stock option exercise dates and stock prices?</td>
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<td>Accounting, Finance</td>
<td>When, if ever, are accruals adjusted?</td>
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<td>Accounting, Finance</td>
<td>What factors should come into play if an accrual adjustment process is implemented?</td>
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<td>How often are accruals trued-up?</td>
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# Accrual process

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<td>Are cost projections completed for all assignment types?</td>
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(Additional rows for potential impact and notes can be added as needed.)
What now?
Next steps for Starbucks

► Gather relevant data on current stock awards and potential future stock awards
► Estimate value of stock compensation
► Estimate tax cost projects based on updated policy
► Obtain final sign off by all corporate stakeholders
► Educate and communicate with local entities (business unit/finance/accounting) on new methodology
► Determine the appropriate date to “go live”
► Manage process closely and measure results
Summary
Implementing a new approach

► Centralize control of accrual management
► Determine owner(s) and key stakeholders of the process
► Communicate and ensure buy-in from the various stakeholders
► Review current and future state
► Estimate financial impact of change
► Agree on process going forward with all stakeholders
Summary
Best-in-class accruals management

► Estimate long-term incentive tax accruals at assignment start via the cost projection:
  ► Include current stock grants and future grants (RSU/options/other)
  ► Include bonus awards
► Expand triggers for accruals adjustments to include new factors such as stock option sales, new stock grants, material changes in home/host country tax rates, material changes to expatriate assignment compensation packages, etc.
► Annually review of all accrual liabilities to:
  ► Clear as needed for expats that no longer have cross-border trailing tax liabilities
  ► True-up accruals annually for significantly over/under accrued balances
  ► Review process, both centrally and locally, to ensure all key components are happening as planned
Questions
Thank you