



Potential Reclassification of Employee Share Options as Liabilities When Adopting Statement 123R

Statement 123R requires employee share options and similar instruments to be classified as liabilities if the employer, under any circumstances, can be required by the provisions of the award to settle in cash, even if the event triggering the cash settlement is remote and even if the instruments had previously been classified as equity under Statement 123 or Opinion 25.¹ Companies will therefore need to reevaluate how they classify their awards when reporting under Statement 123R.

Statement 123R's Requirement

Paragraph 32 of Statement 123R requires an employee share option or similar instrument to be classified as a liability if the terms of the instrument require, or permit at the employee's election, cash settlement on the occurrence of "any" circumstance that is outside the control of the employer. In other words, liability classification is mandatory if the share-based payment plan necessitates a cash settlement of the award based on any circumstance that is beyond the control of the company no matter how unlikely the circumstance's occurrence may be.

The counterpart requirements in Statement 123 and Opinion 25 base liability classification on the likelihood that an event would trigger cash settlement of an award. If the event was not expected to occur, the award was classified as equity if it would otherwise be equity-settled through either gross- or net-share settlement. Liability classification was required only if the contingent event that could require the employer to cash settle occurred or became probable of occurring.

Companies that adopt Statement 123R and must reclassify awards as liabilities because of contingent cash-settlement provisions would have to report the cumulative effect of the change in accounting principle in net income. The cumulative effect would reflect adjusting the previously recorded amount of the award to its fair value at the date of adoption or to intrinsic

Statement 123R's Requirement	1
Contingent Cash-Settlement Provisions	2
Removing Contingent Cash-Settlement Provisions	2

©2001-2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A19805NYGR

Photo: GettyImages/Elizabeth Simpson/Taxi CA08038

¹ FASB Statement No. 123 (revised 2004), Share-Based Payment, December 2004; FASB Statement No. 123, Accounting for Stock-Based Compensation, October 1995; both available at www.fasb.org; Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, October 1972.



value at that date in the case of nonpublic companies that elect the intrinsic-value accounting policy for liability-classified awards. The awards will have to be remeasured at each subsequent financial-statement date until the awards are settled.

Contingent Cash-Settlement Provisions

Share-based payment plans might require that vested awards be cash-settled upon the employee's death or disability. Or they might require cash settlement upon a change in control, a change in company ownership that meets a specified threshold (e.g., 20 percent or more), or a liquidity event, such as an IPO. Plans might also permit the employee to elect cash settlement on the occurrence of these types of events. Liability classification would be required upon adoption of Statement 123R for these and similar provisions of employee share option awards.

However, Statement 123R's classification requirements for awards with share-repurchase features are different from those for share options with cash-settlement features. Paragraph 31, which applies to awards of shares with repurchase features, takes into consideration the likelihood that the event will occur when classifying the award as liability or equity.

Removing Contingent Cash-Settlement Provisions

Companies with contingent cash-settlement features in their employee-share-option plans may decide to remove them. If this is done after the adoption of Statement 123R, the removal would be considered a modification and would be subject to the Statement's accounting requirements for modifications.

If a company removed a contingent cash-settlement provision prior to the adoption of Statement 123R, but did not change either the fair value or the substantive terms of the award, there would be no accounting consequence under either Statement 123 or Opinion 25. The award would then be equity classified when Statement 123R is adopted, assuming it otherwise meets the requirements for equity classification, and compensation cost for any unvested awards would continue to be measured using the award's grant-date fair value.

Companies that remove a contingent cash-settlement feature subsequent to the adoption of Statement 123R, including during the first quarter following adoption, will be required to reclassify the award as a liability at the date Statement 123R is applied. They would be required to remeasure the award at each financial-statement date until the date that the award is modified. This requirement would apply to both vested and unvested awards.



Companies preparing to adopt Statement 123R should reevaluate the terms of their share option awards to determine how they will be classified when the Statement is adopted. They will likely find it necessary to read plan documents to ensure that potential cash-settlement features are considered in applying Statement 123R's classification requirements to employee share option awards. They should in addition consider the company's intent and past settlement practices because a company's history of cash settling awards can also result in liability classification of the award under paragraph 34 of Statement 123R.

This is a publication of KPMG's
Department of Professional
Practice—Audit and Risk Advisory
212-909-5600

Contributing authors:

Jeffrey N. Jones
Paul H. Munter
Mark J. Barrysmith

Earlier editions are available at:
www.aro.kpmg.com

Defining Issues® is a registered trademark of KPMG LLP. © 2001-2005 KPMG LLP, the U.S. member firm of KPMG International, a Swiss cooperative. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. All rights reserved. A19805 NYGR

The descriptive and summary statements above are not intended to substitute for the text of Statements 123R and 123, APB Opinion 25, or any other cited, actual, or potential requirements. Those accounting for share-based-payment arrangements and complying with SEC filing requirements should refer to the texts of the applicable documents that set out requirements and consult their accounting and legal advisors.