



## Alert

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## Revised Statement 123R Classification Requirements for Contingently Cash-Settleable Share Options and Related Guidance for Public Companies

Companies that grant share options and similar instruments with contingent cash-settlement provisions as employee compensation will consider the probability that an event that could require cash settlement will occur when classifying the instruments as liabilities or equity, under a new Staff Position amending Statement 123R.<sup>1</sup> The Staff Position revises Statement 123R's requirement that share options with contingent cash settlement features be classified as liabilities regardless of the event's likelihood of occurrence. Consistent with previous practice in applying APB 25 and Statement 123, companies will classify these instruments as equity if the contingent event is not probable of occurrence, and will not have to re-measure the instruments to fair value each reporting date as is required for liability-classified awards.<sup>2</sup>

Public companies are also required to determine whether some amount for employee share options that are equity-classified under Statement 123R must be presented outside of permanent equity in accordance with ASR 268 and EITF D-98.<sup>3</sup> EITF D-98 applies to share-based employee compensation awards classified as equity as of the date the company adopts Statement 123R.

The new Staff Position and the application of EITF D-98 may affect the many companies that have provisions in their employee share-option awards that could require the company to cash settle if specified events occur. Some of the common contingent events that might trigger cash settlement of employee share options are a change in control of the company, a significant change in ownership of the company (e.g., 20 percent or more), an IPO or other significant liquidity event, and death or disability of the share-option holder.

<sup>1</sup> FASB Staff Position No. FAS 123(R)-4, Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event, February 3, 2006; FASB Statement No. 123 (revised 2004), Share-Based Payment, December 2004; both available at [www.fasb.org](http://www.fasb.org).

<sup>2</sup> APB Opinion No. 25, Accounting for Stock Issued to Employees, October 1972; FASB Statement No. 123, Accounting for Stock-Based Compensation, October 1995, available at [www.fasb.org](http://www.fasb.org).

<sup>3</sup> SEC Accounting Series Release No. 268, Presentation in Financial Statements of "Redeemable Preferred Stocks," July 27, 1979, available at [www.sec.gov](http://www.sec.gov), and EITF Topic No. D-98, Classification and Measurement of Redeemable Securities, available at [www.fasb.org](http://www.fasb.org).

### Revision of Statement 123R

The new requirements amend Statement 123R to require companies with contingent cash-settleable provisions in their employee share-option awards to assess the probability of the contingent event's occurrence when classifying the instruments as liabilities or equity. If the event's likelihood of occurrence is less than probable and the instrument would otherwise be classified as equity, it would be equity-classified. The Staff Position conforms the Statement's accounting requirements for *share options* granted as employee compensation to its accounting requirements for *shares* issued as employee compensation.

Companies would be required to make an ongoing assessment of the probability of the contingent event's occurrence as long as the instrument is outstanding. If the contingent event becomes probable of occurring, the share option would become liability-classified at that date. The reclassification would be accounted for in the same way as a modification that changes an award from equity- to liability-classified. Additional compensation cost would be recognized at the reclassification date if the fair value of the award at that date exceeds its grant-date fair-value amount. Compensation cost would be recorded to reflect subsequent increases and decreases in the fair value of the award for as long as the award remains liability-classified. However, the cumulative compensation cost recognized would never be less than the share option's grant-date fair value.

The Staff Position's guidance applies only to share options or similar instruments issued to employees as compensation and cannot be

applied, even by analogy, to other instruments, including share-based payments issued to nonemployees.

**Transition.** Companies that have not previously adopted Statement 123R are required to apply the Staff Position as of the date that Statement 123R is adopted. A calendar-year-end company that is adopting Statement 123R on January 1, 2006 would therefore begin applying the Staff Position on the same date.

Companies that previously adopted Statement 123R and classified contingently cash-settleable employee share options in a manner consistent with the guidance in the Staff Position would continue to apply that accounting going forward and would not revise their previously issued financial statements.

Companies that adopted Statement 123R before the Staff Position was issued and treated share options or similar instruments that allow cash settlement if a contingent event occurs as liabilities in accordance with Statement 123R's original guidance will retrospectively apply the Staff Position's guidance to prior-period results when those amounts are included for comparative purposes in subsequent financial statements. In that way, the company will report all comparative periods for which Statement 123R is applied with the instruments classified in accordance with the guidance of the Staff Position.

### Applying EITF D-98 to Equity-Classified Share-Based Employee Compensation Awards

EITF D-98 may require public companies to classify outside of permanent equity some amount for share-based instruments with

contingent cash-settlement features that are beyond the company's control. According to the guidance in SAB 107 and informal discussions with the SEC staff, the amount that would be reclassified outside of permanent equity for share options with contingent cash-settlement features that are beyond the company's control would be based on the grant-date *intrinsic value* of the award, regardless of whether the award was granted before or after the adoption of Statement 123R.<sup>4</sup> The amount to be reflected outside of permanent equity would be the grant-date intrinsic value of the award multiplied by the proportion of the award vested to date. If the contingent event is not probable of occurrence and the granted share-option awards had no grant-date intrinsic value (i.e., the exercise price equals the stock's market price at the date of grant), no amount would be recorded outside of permanent equity related to those awards.

For an award, such as a restricted stock grant, that is issued "in-the-money" and, therefore, with intrinsic value at the date of grant, the grant-date intrinsic value would be classified outside of permanent equity in proportion to the vesting of the award. This guidance applies whether the award was initially accounted for under APB 25, Statement 123, or Statement 123R. Changes in the award's intrinsic value subsequent to the grant date do not affect the amount that is recorded outside of permanent equity if the award is neither currently redeemable nor probable of becoming redeemable. If the contingent event permitting cash settlement becomes probable of occurrence, the award would be liability-classified and EITF D-98 would no longer apply.

<sup>4</sup> SEC Staff Accounting Bulletin No. 107, Interaction Between FASB Statement No. 123(R), and Certain SEC Rules and Regulations Regarding the Valuation of Share-Based Payment Arrangements for Public Companies, available at [www.sec.gov](http://www.sec.gov).

Amounts classified outside of permanent equity for awards with repurchase features that make the instruments currently redeemable or that will become redeemable are computed differently from the amounts described above for awards with contingent cash-settlement and repurchase features that are not probable of occurrence. EITF D-98 requires amounts classified outside of permanent equity for employee share-based awards that are equity-classified and currently redeemable or that will ultimately become redeemable based on the passage of time (e.g., a share option for which the underlying shares are redeemable for cash six-months after exercise) to be determined based on their then current intrinsic values for vested awards and at their then current intrinsic values in proportion to vesting for unvested awards at each balance-sheet date. Those adjustments would be recorded as reclassifications between permanent and temporary equity but do not affect earnings available to common shareholders in EPS calculations provided that the shares involved are common shares and redemptions are at fair value.

### Illustrations

The amount to be reclassified outside of permanent equity is illustrated below in different circumstances for employee share-based payment awards that are equity-classified.

Assume ABC is a calendar-year reporting company that previously applied APB 25 in accounting for share-based payments. ABC adopts the provisions of Statement 123R as of January 1, 2006. Here are the facts.

- Number of employee share options outstanding: 1,000
- Grant date: January 1, 2004
- Cliff vesting: 4 years from date of grant
- Exercise price: \$10. The \$10 exercise price equaled the market price of ABC stock at the date of grant (i.e., there was no intrinsic value at the grant date)
- Market price of ABC stock at March 31, 2006: \$25

### *Awards with Contingent Repurchase*

**Feature.** ABC's share options provide for cash settlement at the employees' request upon a change in control or other contingent event beyond the company's control. ABC must evaluate the likelihood that these contingent events will occur. The occurrence of the specified contingent event is considered to be less than probable. The company would classify the share options in equity under Statement 123R as amended by the Staff Position. In that situation, ABC would determine the amount that should be classified outside of permanent equity in accordance with EITF D-98. Because there was no intrinsic value at the date of grant, no amount would be classified outside of permanent equity. In contrast, if the occurrence of the contingent event is considered probable at January 1, 2006, ABC would recognize the earned portion (50 percent) of the fair value of these share options as a liability when adopting Statement 123R. The continued vesting of the share options and subsequent adjustments in their fair value would be recognized as compensation cost.

**Award Redeemable Six Months from Date of Share Issuance.** If the share-option plan allows employees to require ABC to repurchase the underlying shares six months or more after the underlying shares are issued, ABC would classify the instruments in equity under Statement 123R and would be required to apply EITF D-98. Based on the guidance in SAB 107, ABC would report the intrinsic value of the award at each balance-sheet date as the redemption amount. It would be adjusted for the proportion of employee services provided to date to determine the amount to record outside of permanent equity. At March 31, 2006, the amount reported outside permanent equity would be \$8,438 (1,000 share options x \$15 x 27/48 months). The \$15 represents the intrinsic value at March 31, 2006, and the portion vested is 27 months of a 48-month vesting period.

**Change in Facts.** Assume the same circumstances already described except the market price of the stock on the grant date was \$14 (i.e., there was \$4 of intrinsic value at the grant date).

### *Awards with Contingent Repurchase*

**Feature.** The occurrence of the specified contingent event is considered to be less than probable. ABC would therefore classify the instruments in equity under Statement 123R. The amount classified outside of permanent equity at March 31, 2006 would be \$2,250 (1,000 share options x \$4 grant-date intrinsic value x 27/48 months). The amount for instruments with contingent repurchase fea-



tures reclassified outside of permanent equity is not remeasured after the grant date if the contingent event's occurrence is not probable.

***Award Redeemable Six Months from Date of Share Issuance.*** The amount to be reported outside of permanent equity would be the same as in the unchanged set of circumstances above for awards redeemable six months from the date of share issuance because the award is adjusted each period to reflect the current intrinsic value of the award.

The descriptive and summary statements above are not intended to substitute for the text of Statements 123R and 123, APB Opinion 25, the FASB Staff Position FAS 123(R)-4, EITF D-98, SAB 107, and ASR 268 or any other cited, actual, or potential requirements. Nor are any of the cited documents necessarily applicable to any entity's specific circumstances. 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.

This is a publication of KPMG's  
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