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FASB COMPLETES OPINION 25
INTERPRETATION PROJECT --
EXPOSURE DRAFT TO BE ISSUED IN MARCH

On December 4, the Financial Accounting Standards Board ("FASB") completed its project to issue an interpretation of APB Opinion 25, the comprehensive standard governing the accounting treatment of equity incentives for employees. Opinion 25 was first adopted by the FASB's predecessor body in 1972, and has governed the accounting treatment of stock compensation plans ever since. The FASB had expected that its own standard on stock compensation plans, FAS 123 -- *Accounting for Stock-Based Compensation*, issued in 1995, would *replace* Opinion 25. In response to pressure from constituents and Congress, however, the FASB decided to let companies choose between adopting FAS 123 or retaining Opinion 25 for purposes of P&L expense reporting. Since virtually no company has adopted FAS 123 for reporting purposes, Opinion 25 remains the ruling standard.

Over the years since Opinion 25 was adopted, new types of employee stock grants have evolved and practice has become more diverse and sophisticated. A variety of interpretative issues have arisen which the FASB expected to become moot with the issuance of FAS 123, but which now remain unsettled. Thus, the FASB embarked on a project in 1996 to resolve these issues. The Opinion 25 project involved interpretations of 13 issues. These issues and the FASB's preliminary interpretations of them are described on the Attachment.

The most important changes proposed by the FASB are:

1. Stock options granted to non-employee directors (and other non-employee service providers such as leased employees, consultants and independent contractors) would require a charge to earnings for the options' "fair value" at vesting

2. Repriced stock options would be treated as variable grants involving a charge to earnings for option gains at exercise

3. Companies would be able to issue stock in subsidiaries to subsidiary employees, subject to repurchase rights, and treat the grants as fixed grants under Opinion 25 in certain circumstances

4. Discretionary modifications to outstanding grants that enhance the "fair value" of the grant to employees would involve a new measurement date and additional compensation expense under certain circumstances

The next step in the process is for the FASB to issue an Exposure Draft of the proposed Interpretation. This is expected in March of next year. There will then be a period for public comment lasting three months following which the FASB will reconsider its preliminary interpretations and issue a final Interpretation that will be binding on all companies which use Opinion 25 to account for equity grants. The final Interpretation is expected to be issued in September 1999.

The Interpretation will be effective for financial statements issued after the release of the final Interpretation, but will be applied to transactions (i.e., new grants, modifications to existing grants, including repricings, and changes in employee status) that occur after December 15, 1998. There would be no retroactive effect on financial statements issued between now and the date the new Interpretation is effective. For example, if a stock option is repriced now at $40, but the market value of the stock at the effective date is $50, variable expense need only be measured from $50. Also, if outside directors receive stock options now, which become 60% vested by the effective date, fair value for only the unvested portion will be required to be expensed.

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The purpose of this letter is to alert compensation professionals to an important development that will affect companies' use of equity incentives for their employees and directors. General questions may be addressed to Fred Cook at (212) 986-6330. Specific questions affecting a company's actual financial statements should be taken up with qualified accounting professionals.

Copies of this letter and other published materials are available on our web site, WWW.FREDERICWCOOK.COM.