June 9, 1998

FASB MAKES PROGRESS ON INTERPRETING
OPINION 25 ACCOUNTING RULES ON EMPLOYEE STOCK OPTIONS

-- Likely Negative Effect on Director Plans, Grant Modifications and Employee Stock Purchase Plans with Look-back Features --

On December 17, 1996, the Financial Accounting Standards Board (FASB) announced it would undertake a project to address a number of open issues on accounting for stock options and other equity grants under APB Opinion 25[1]. This has been dubbed the Opinion 25 "Repairs and Maintenance Project."

The FASB worked for 11 years (1984-95) to develop a new accounting standard to *replace* Opinion 25, but finally decided that the new standard (SFAS 123, Accounting for Stock-based Compensation) would be *optional*, and that companies could continue to rely on Opinion 25 for expense purposes if they so chose. Since virtually all companies have elected to stay with Opinion 25, despite the FASB's encouragement that they adopt SFAS 123, the FASB decided it would need to separately resolve certain practice issues that had arisen during the 25-plus years Opinion 25 has been effect. While it is clear the project is only an interpretation of Opinion 25, and that fundamental precepts of grant date as the measurement date and intrinsic value as the measurement method for most grants will not be changed, it is expected that the FASB's interpretation of Opinion 25 will be highly conservative and result in less flexibility in operating under Opinion 25.

The FASB has held three meetings on the Opinion 25 project so far in 1998, on April 8 and 15 and on May 20. Of the 13 issues identified for resolution, tentative decisions on five have been reached (see Attachment). Based on the deliberations so far, we believe the compensation community can expect the following from the FASB:

1. Stock options and other equity grants to outside directors no longer receive favorable accounting treatment under Opinion 25.

    — Opinion 25 will be limited to grants to employees.

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[1] See our letter of January 10, 1997

- Options to directors will most likely involve a charge to earnings equal to “fair value” on their vesting date (see EITF 96-18).

- Restricted stock grants to directors could involve variable compensation expense until vesting.

2. If an employee with an unvested grant terminates employment but continues to serve the company as an independent contractor or consultant, then the intrinsic value of the unvested portion of the grant at termination may need to be expensed over the remaining vesting period because the person providing services is no longer an employee.

3. Modifications to outstanding grants that add more than *de minimis* value may trigger a new measurement date and compensation expense for the grant’s intrinsic value (the “spread”) when the modification is made.

   - This new expense, if any, will be net of previously expensed intrinsic value.

4. The acceleration of an outstanding grant’s vesting by an event *not* contemplated in the original grant terms may trigger a new measurement date, with the potential for new or additional compensation expense.

   - For example, if a person retires with an unvested grant and vesting is accelerated, there would be a compensation expense if the acceleration of vesting was discretionary, but no expense if it was provided for in the agreement.

5. Employee stock purchase plans with “look-back” features (for example, option price is *lower* of 85% of market value on grant date or purchase date) will no longer be “noncompensatory” under Opinion 25.

   - Compensation expense would be variable and measured by the intrinsic value at exercise.

   - However, a grant with an option price of no less than 85% of the stock’s fair market value at grant (and no “look-back” feature) should continue to be regarded as “noncompensatory” under Opinion 25.

These and other preliminary decisions expected to be reached by the FASB during the ensuing months are likely to be controversial. The FASB expects to issue an exposure draft of a proposed FASB Interpretation during the fourth quarter of 1998, but this may be optimistic. When it is released, a comment period of at least 60 days will follow.

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General questions may be addressed to Fred Cook at 212-986-6330. Questions specific to a particular company's practices should be addressed to the company's accounting professionals.