

August 5, 1998

**UPDATE ON FASB
OPINION 25 STOCK
COMPENSATION PROJECT**

During the course of the Financial Accounting Standards Board's 10-year long project to change the accounting treatment for employee stock options and other equity grants, the FASB expected that the new accounting standard would *replace* the current accounting treatment under Accounting Principles Board (APB) Opinion 25 (*Accounting for Stock Issued to Employees*) which has been in effect since 1972. Instead, the new standard (FAS 123, *Accounting for Stock-Based Compensation*) was made optional so that companies could chose between Opinion 25 and FAS 123 in recognizing compensation expense for stock-based awards to employees.⁽¹⁾ This meant that various interpretative issues that had arisen over the years under Opinion 25 as practice evolved were not settled.

Consequently, in August of 1996 the FASB launched a project, dubbed the Opinion 25 "Repairs and Maintenance Project," to provide accounting guidance on 13 issues.⁽²⁾ The expected outcome of this project is a FASB Interpretation of Opinion 25 that will address those issues *within* the existing framework of Opinion 25 but will *not* change the fundamental precepts upon which Opinion 25 is based, namely, the measurement date for fixed plans is the date of grant, and the measurement method is intrinsic value (e.g., fair market value minus exercise price) on the measurement date.

The FASB has met five times so far on the Opinion 25 interpretative project (April 8, April 15, May 20, June 10 and July 15), and we have written you about the first three of these meetings.⁽³⁾ A summary of the 13 issues and preliminary decisions on eight of these is attached. A summary of the FASB's preliminary decisions made on June 10 and July 15 follows:

Issue 1 – Scope of Opinion 25

- Opinion 25 only applies to stock of the employer issued to an employee. What happens if a parent company grants its own stock to an employee of a subsidiary? The FASB concluded that the parent could account for the grant under Opinion 25 in its own consolidated financial statements. But if the subsidiary issues its own financial statements to the public (whether for equity or debt securities), then any grant of parent company stock to subsidiary employees could not be accounted for

(1) See our letter of November 8, 1995

(2) See our letters of August 26, 1986 and January 10, 1997

(3) See our letter of June 9, 1998

under Opinion 25 because it is not stock of the employer. Rather the grant would have to be accounted for at “fair value”

- In cases where a company grants options to employees of a subsidiary in which it does not have a controlling interest (e.g., owns 50% or less), it may have to account for the grant under FAS 123
- It is expected that these tentative decisions will be controversial because they are a change from established practice

Issue 3 – Plans with puts, calls and rights of first refusal to repurchase shares for cash

- For companies with publicly traded stock, grants with puts, calls or rights of first refusal will not cause an otherwise fixed-accounting grant to be treated as a variable plan unless shares are expected to be repurchased within six months of the shares being issued.
- If the company is privately held, grants with puts, calls or rights of first refusal will not cause an otherwise fixed grant to receive variable-plan treatment *so long as* either (1) the purchase and repurchase price reflects the shares’ “fair value” and the shares are not expected to be bought back within six months of issuance, or (2) the purchase and repurchase price does not reflect the stock’s “fair value,” but there is a substantial investment which bears normal risks and rewards of ownership

Issue 4 – Grants by subsidiaries of public companies

- Subsidiaries of public companies or public companies with thinly traded stock are to be treated as public companies for purposes of APB Opinion 25
- Thus, if a *subsidiary of a public company* grants or options its own shares to its employees and includes puts, calls or rights of first refusal to provide employees with liquidity, an otherwise fixed grant will receive fixed accounting treatment so long as it meets the same conditions identified in issue 2 above.

Issue 6 – Cash settlements of earlier awards

- If cash is paid to settle an outstanding option or to buy back shares shortly after exercise or issuance (i.e., within six months), compensation expense is measured by the *greater of* the cash paid or the awards’ intrinsic value at grant

Issue 7 – Modifications to outstanding awards that add more than “de minimis” value

- Modifications to outstanding grants will trigger a new measurement date (and potentially new compensation expense) if the “fair value” of the modified grant measured at the modification date for the remaining *contractual* (not expected)

term is more than a *de minimis* increase in the “fair value” of the grant before modification

- While the test of an increase in value uses the “fair value” methodology of FAS 123, any additional compensation expense as of the modification date would be based on the intrinsic value method of Opinion 25

Issue 9 – Accounting for accelerated vesting

- Accelerated vesting that is not part of the original terms of the grant is a plan modification requiring a new measurement date and possibly new compensation expense (see Issue 7); acceleration of vesting which occurs when termination of employment is imminent would increase the option’s “fair value” under FAS 123 because shares which would have been forfeited have been reinstated
- Changes in fair value would be measured over the grant’s remaining *contractual* term, with new compensation expense measured by the stock’s (or the option’s) intrinsic value on the date of accelerated vesting in excess of any intrinsic value at grant
- Acceleration of vesting which does *not* relate to a termination of employment is not likely to result in a new measurement date (and new compensation expense) because vesting is not a factor which influences “fair value” under FAS 123

Issue 13 – Accounting for noncompensatory “Section 423 plans” with a look-back option

- A broad-based employee stock option or purchase plan will be noncompensatory so long as the option price is no lower than 85% of market value at *grant*, and the other requirements for Opinion 25 are met. The grant also will be noncompensatory if the option price is no lower than 85% of market value at exercise. However, it will *not* be a noncompensatory grant if the option price is the *lower of* 85% of market value at grant or exercise -- a so-called “look-back” option
- The FASB may readdress whether plans with a “look-back” feature are automatically compensatory at a future meeting

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The next FASB meeting on the Opinion 25 project will be held August 12, at which time issues 8 and 13 will be discussed. It is now expected that an Exposure Draft for a new Interpretation of Opinion 25 will be released during the first quarter of 1999. We will update the attached summary and keep you informed of developments as they occur.

Questions of a general nature may be addressed to Fred Cook at (212) 986-6330.