

June 24, 2004

Letter of Comment No: 4793 File Reference: 1102-100

VIA E-MAIL

Director of Major Projects - File Reference No. 1102-100 Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

Re: FILE REFERENCE No. 1102-100: Invitation to Comment on Accounting for Stock-Based Compensation

Dear Sir or Madam:

The Semiconductor Industry Association (SIA) appreciates the opportunity to submit comments for consideration as the FASB considers changes to the U.S. accounting standards on stock-based compensation. The SIA represents over 85 percent of the U.S. semiconductor industry – our members represent the largest semiconductor makers in the United States¹. SIA and its members believe providing the investing public with transparent, accurate and comparable financial information is of paramount importance and any changes to the rules must bolster this goal – we do not believe that expensing options would lead to more accurate or transparent financial statements. Further, stock options do not meet the definition of an expense and existing models available to value options do not adequately value employee stock options. Because our companies provide broad based stock option plans, these inaccuracies are likely to be material to earnings. We further firmly believe that any proposed change to accounting rules of this magnitude must be field tested prior to enactment. In addition to the substantive accounting based issues the proposed standard raises, SIA also has concerns about the impact a potential expensing rule could have on the international competitiveness of American companies.

No Reliable Valuation

Accountants in academia, the private sector and the public sector have yet to agree on the question of how to value stock options. Employee stock options truly are unique financial instruments, which differ significantly from the type of options for which the Black Scholes and binomial models were designed -- which is why valuation remains an intractable challenge.

Whereas tradable options are sold on the open market, employee stock options may only be
granted to employees. In other words, employees are the only holders of employee stock
options, and there is no open market for these instruments. In its draft, FASB notes that the
most accurate determination of fair value requires a willing buyer and a willing seller –

¹ The Semiconductor Industry Association (SIA) is the leading voice for the semiconductor industry and has represented U.S.-based manufacturers since 1977. SIA member companies comprise more than 90% of U.S.-based semiconductor production. Collectively, the chip industry employs a domestic workforce of 284,000 people.

however, by definition, such an arrangement cannot exist for employee stock options, which are highly restricted.

- Employee stock options are not actually stock options until they vest, which may occur on periodic fixed dates or on a single fixed date several years out in the future.
- Employee stock options are not transferable to anyone at any time, even to another employee of the issuer. This means that neither the employee stock options agreement nor the option itself can be sold either before or after it vests. As a result, the only way that an employee can benefit financially from an employee stock option is to stay with the employer until the option vests, then exercise it and sell the underlying stock.
- Estimates of volatility have the potential to have the biggest impact on value under the Black Scholes and binomial models. However, estimating future volatility during the period of a long-lived employee option – which is significantly different than estimating volatility for a typical short duration publicly traded option -- is highly susceptible to errors and manipulation. Indeed, many believe that volatility is the single most unreliable factor under Black-Scholes or under a binomial model.

The exposure draft, we believe, does not give sufficient guidance on either model – the result will be a requirement that companies rely almost entirely on conjecture and speculation in formulating their stock option expense. Such an approach will mean that the resulting financial statements will be highly inaccurate and lack comparability – a step backwards in the goal of providing transparency and easily comprehensible financial information to investors.

Options Do Not Represent An Expense

Current accounting rules rightly dictate that an expense is to be recognized only if it can be reliably measured. As already noted, current valuation models do not meet this test – they can correctly value neither the value to the employee nor any supposed cost to the granting company. Mandatory recognition of an expense that cannot be reliably measured flies in the face of the most fundamental accounting rules.

Certain estimates, such as depreciation, are included in company financials. However, no other estimates involve the same degree of uncertainty in terms of value as do stock options. In the case of depreciation, a company knows with certainty the amount that it paid for an asset being depreciated, but under the accounting rules, it is not allowed to expense the entire amount paid in the year of acquisition. Instead, the company must estimate the useful life of the item and expense a pro-rata portion each year. Thus the only estimate is one of timing, not value because there is certainty with regard to exactly how much the item cost.

By contrast, with stock options there is no reliable measure of "cost". In fact, there is no certainty that the option will be exercised at all. Under the proposed mandatory expensing scheme, though, a company would be required to record an expense up front, without recourse to any kind of truing up mechanism for estimates that ultimately prove to be wrong.

An employee stock option is an incentive compensation instrument designed to attract and retain the best available employees, and to provide an equity stake in order to increase the employee's productivity to a level in excess of that which could be achieved by cash or fringe benefit compensation alone. Accordingly, the express purpose of an employee stock option is not to raise new equity capital but to increase the value of the issuer's existing equity. The granting of

employee stock options does not result in the creation of a quantifiable liability and leaves the employee with no claim on the assets of the firm – instead, options represent a means of allowing employees to reap the rewards of ownership. As a result, the granting of employee stock options does not meet the accounting definition of an expense. Instead, options represent dilution of ownership which is disclosed under current rules.

Materiality

The broad and deep dispersion of options to all levels of employees within SIA member companies makes potential inaccuracies in valuation more troubling. Companies that issue only a small number of employee stock options – typically to top executives – will be less sensitive to inaccurate valuations being included in their financial statements because those numbers may be so small as to be immaterial. This situation appears to characterize many of the companies that have chosen to expense their employee stock options. SIA members, though, grant options to a large segment of their workforce and so fear the inclusion of a large, inaccurate expense. With the same number of options outstanding, companies could experience wild fluctuations in their reported earnings – these fluctuations would have no relation to the financial well-being or performance of the company.

SIA members believe that current accounting rules rightly require detailed disclosure on option grants, including their potential dilutive effects. In addition companies must report their "diluted" earnings which adjusts share count for dilution. Impact on earnings per share and dilution caused by option grants, therefore, is information that should be made available in a consistent manner to shareholders. If an additional expense was added — in addition to calculating dilution — the effect of options grants would essentially be counted twice.

In addition, Sarbanes Oxley requires CEO certification of financial statements. Making such a certification of financial statements that include an expense for employee stock options would be virtually impossible for those whose companies offer broad based plans where the number would be likely to be material to earnings because of the inability of companies to accurately value stock options.

Employee Stock Purchase Plans (ESPPs)

Stock option expensing would also likely doom Employee Stock Purchase Plans (ESPP), which many SIA member companies also offer their employees. ESPP plans allow all eligible employees to buy company stock at regular intervals using ongoing payroll deductions. Usually the amount of the discount is 15% -- yet proposed changes would require expensing of any options granted with more than a 5% discount. It is very likely that many companies will not bother with a 5% discount and these plans will cease to be offered. These plans are open to 100% of our workforce, and employees actively participate in these plans. It is a very real way for employees to benefit as the value of a company increases, thus improving productivity. And when productivity improves, shareholder value goes up. In this way, all of the investors in a company benefit from ESPP plans.

I would also like to reiterate that in our industry, stock options are routinely granted to those well below the executive level --- 80-95 percent of options are granted by our members to those below the senior executive level. Options allow us to insure that our employees are able to fully share in the success they have helped make possible. In addition, stock options are a key

means by which we attract and retain our best employees. Our members are engaged in constant global competition for the best and brightest engineers from around the world and we must offer those employees the potential to enjoy the success they help generate through an equity stake – requiring expensing would severely limit our ability to compete for talent through such equity participation.

Ultimately, accounting rules must provide clarity into the financial health and activities of the firm, and provide the investing public with confidence that they have the ability to accurately assess a business entity based on the information disclosed – requiring the expensing of stock options in the manner laid out in the FASB exposure draft will in fact be detrimental to both objectives. The current FASB standard is a workable and effective means of providing investors with precise information, and it avoids the inclusion of potentially misleading expense charges in company financial statements. The disclosure-based standard embodied in FASB Statement 123 is the best approach to employee stock option accounting. I would be happy to answer any questions you might have regarding our position.

Sincerely, Seeling

George Scalise

President