

Letter of Comment No: 5837  
File Reference: 1102-100

June 30, 2004

Director of Major Projects  
Financial Accounting Standards Board  
401 Merritt 7  
PO Box 5116  
Norwalk, CT 06856-5116

*Re: File Reference 1102-100*

Dear Sir or Madam:

We appreciate the opportunity to comment on your Exposure Draft, entitled "Share-Based Payment - an amendment of Statements No.123 and 95" (the "Exposure Draft"). We believe the Exposure Draft deviates from FASB's stated objectives of establishing accounting and reporting standards that provide credible, concise, transparent and understandable financial information that is consistent among enterprises. We strongly agree with those stated objectives, and accordingly, we do not agree with the proposal to expense employee stock options as outlined in the Exposure Draft. Our primary concerns with the Exposure Draft can be summarized as follows:

- Employee stock options granted at market price do not constitute an "expense" under present accounting definitions, do not represent an economic cost to the issuer and should not be recognized as a compensation expense of the issuing company.
- The measurement methodologies and tools recommended by FASB rely significantly on management judgments and estimates and will lead to a lack of consistency and comparability among reported results.
- FASB should implement a plan for comprehensive field testing, before adopting any new standards, to gain an adequate understanding of the range of practical issues arising from the measures outlined in the Exposure Draft.

Each of these concerns is examined in greater detail below.

### **Employee Stock Options are Not an Expense**

Micron strongly disagrees with FASB's conclusion that issuance of equity instruments in exchange for employee services give rise to recognizable compensation costs of the issuing company.

We believe the fundamental objectives of financial reporting center around providing information about an enterprise's economic resources, obligations and owners' equity. FASB Statement of Concepts No. 1, states "Over the life of an enterprise (or other very long period), total reported earnings equals the net cash receipts excluding those from capital..." Furthermore, FASB Statement of Concepts No. 6, states "Expenses represent actual or expected cash outflows (or the equivalent) that have occurred or will eventuate as a result of the entity's ongoing major or central operations." (We note the accrual method of accounting is used to allow for differences between the timing of the effects on results of operations and the actual flow of cash.) The conceptual relationship between a company's long-term results of operations and its cumulative cash flows is fundamental to investors' valuations. The proposed mandatory expense recognition for employee stock options represents a hypothetical expense for which there is no current or future cash flow. This would result in a permanent difference between a company's results of operations and the actual or expected cash flows, and necessitates investors' adjustment of the expense the Exposure Draft requires.

The Exposure Draft's stock option expense that results is truly unique in accounting in that there is never a "true-up" of the estimate. Because option lives and the volatilities of long-lived, non transferable employee stock options are not known at grant date and are subject to revision and refinement as actual events become known, the imperative to true-up an expense couldn't be higher. It is not apparent how FASB reconciles the requirement to periodically update all other estimates necessitated by generally accepted accounting principles, and ignore adjusting this employee stock option expense.

The impact to a company as a result of the granting of employee stock options is the dilution of shareholders, a cost which is already reflected in the computation of earnings per share. The dilution of shareholders' equity is reflected in the computation of EPS by application of the Treasury Stock Method. To require expense recognition in addition to the ownership dilution would effectively double-count employee stock options.

### **Valuation Methods Lead to Lack of Consistency and Comparability**

The Exposure Draft's proposed valuation methods will not provide a reasonable approximation of the cost of employee stock options. Problems with using the proposed binomial or Black-Scholes option valuation methods to value employee stock options have been well documented. Problems with the option valuation models can be summarized into three primary categories:

- 1) The proposed option valuation models do not accurately estimate values of the short-term, exchange traded stock options for which they were designed.
- 2) The proposed valuation methods do not accurately address the significantly different characteristics of long-term, employee stock options which are not publicly traded.

- 3) The stock option valuation models are dependent on inputs that cannot be accurately estimated.

A number of empirical studies have questioned whether the valuation models can accurately estimate values of the short-term, publicly traded stock options for which they were designed. Many researchers have challenged whether the distribution of stock option prices is truly lognormal, a central tenet of the valuation models. Further, even for short-term exchange traded options there are differences in opinion on how critical volatility inputs should be measured. While we can not conclude that option valuation models accurately estimate the value of short-term exchange traded options for which they were designed, there are even greater problems when the valuation models are applied to employee stock options. Numerous problems with applying option valuation models to employee stock options have been cited by academics and others. A fundamental problem is that employee stock options generally are not transferable or tradable so an employee can only realize value through an exercise which results in forfeiture of the option's future time value. Further, employee stock options are not hedgeable. These features make the employee stock options worth less than exchange traded options, but the proposed statement does not provide for a discount, resulting in an inherent overstatement of compensation expense.

The proposed statement would also result in the overstatement of compensation expenses related to employee stock options because the calculation methodologies do not adjust for the nature of employee stock awards. Stock option awards are inherently worth less to an employee than an external investors' exchange traded options for the following reasons:

- 1) An employee's risk tolerance cannot wholly align with the terms of the option award.
- 2) An employee's liquidity needs vary over the life of an option award.
- 3) A typical employee does not have sufficient information or sophistication to properly value of the award, and thus there is a valuation discount.
- 4) An employee's diversification needs are not compatible with option awards.

For the aforementioned reasons, employees will not place the same value on their options as an external investor does on exchange traded options. The proposed standard does not recognize this key difference, resulting in a systematic overstatement of employee stock awards.

The greatest problem with the proposed valuation method for employee stock options is the inability to accurately determine input variables used in the model. Slight changes in the expected term of the option or the expected volatility of the price of the underlying share have a dramatic effect on the value of the option yet there is no way to reliably estimate these variables. For Micron, which has experienced historically high volatility and constantly changing exercising patterns, utilization of two alternative reasonable, supportable estimates of the model variables would result in a computed cost that varied by more than 100%. By the Exposure Draft's provisions, both of those results would meet the approximately right characterization, but would be virtually useless to the investment community.

Micron has historically experienced dramatic changes in our operations and market. The following are examples of some of these changes:

- In 1998 we acquired the operations of one of our major competitors, which more than doubled our manufacturing capacity, enabling us to increase our market share in the DRAM industry from approximately 7% to approximately 20% in less than three years,
- In 2000 we disposed of our PC operations, which had constituted more than 50% of our net revenue in fiscal year 1998.
- We have pursued a number of new markets outside our core DRAM operations that could significantly change the nature of our business.
- Our primary industry DRAM has cycled through severe imbalances in supply/demand relationships of our commodity product over the last 10 years leading to dramatic changes in our operating results and stock price.
- The DRAM industry has also undergone a major consolidation with many firms exiting the business and a small number of companies holding greater than 75% of market share.

The dramatic changes in our business resulting from the aforementioned and other changes greatly diminish the likelihood that the historical volatility of the Company's stock prices is representative of the future volatility of the Company's stock price. Factoring any changes into expected volatility is highly subjective at best and fraught with error. For example, most outside analysts predicted that consolidation of the DRAM industry would lead to greater stability and less volatility in market pricing. Actual results over the past few years have been exactly the opposite as volatility increased.

Accurately estimating the expected term of employee options is equally difficult. Historical exercise behavior is dependent on a number of factors that are constantly changing such as the following:

- Spikes and drops in our stock price which change employee perceptions of risk and return of their stock options.
- Recent success of the Company which alters employees' personal financial position as a result of the Company's compensation plans being significantly variable.
- Changes in the demographics of the Company's employees which have become significantly more international and older as the Company matures.

The average term of the Company's employee stock options has varied substantially in recent periods due to market conditions and changes in behavioral factors. There is no reliable method to estimate the affect of changes in behavioral factors on the expected term for employee options.

Under the proposed statement, a company's ability to accurately estimate the variables required in stock options valuation model would be severely constrained. Paragraph B17, of the proposed standard asserts that "Data and assumptions used to estimate the fair value of equity and liability instruments granted to employees should be determined in a consistent manner from period to period." To avoid the appearance of being inconsistent or of manipulating earnings companies will likely avoid the subjective and difficult adjustments to variables that are necessary to accurately reflect real changes in current conditions. The Exposure Draft creates a very significant dilemma for an issuer. Adjustments to how model inputs are estimated could create issues with independent auditors and subject the company to increased litigation risk.

It is our position that a flawed valuation model based on inaccurate variables will not result in a reasonable approximation of the cost of employee stock options. We strongly disagree with the Board's contention that for employee stock options it is better to record a cost that is "approximately right" than to not record any cost for several reasons:

- 1) Recording transactions based on unreliable data gives the impression that the information has much greater precision than it does.
- 2) Based on reasonable estimates of data inputs there is little confidence that the calculated cost of stock awards is closer to the actual value of the award than a \$0 value.
- 3) Unlike other cost accruals which merely allocate expenses between periods, stock option valuation result in estimation differences that are permanent and never reconciled.
- 4) The valuation method in the proposed standard results in a systematic overstatement of compensation expense by failing to account for certain differences between employee and exchange traded options.

### **Need for Field Testing**

As is evidenced by the overwhelming response to the Exposure Draft from business leaders, financial experts, investor activists, academicians and the media, there is no consensus on what constitutes appropriate treatment of employee stock options. In order to achieve a workable consensus we believe it is imperative that FASB implement rigorous and widespread field testing *before* any new standards are adopted. To be effective any such field testing must include companies that range from large multinationals to small domestic start-ups. Widespread field testing would provide FASB with a forum for identifying, understanding and addressing the practical challenges and implications of the proposed standards. We understand that FASB has successfully used this type of field testing in the past and encourage you to do so again.

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Thank you for giving us the opportunity to comment on the Exposure Draft. If you have any questions or need any additional information from us as you deliberate your course of action, please do not hesitate to contact me at (208) 368-4621.

Very truly yours,

/s/ W. G. STOVER, JR.

W.G. Stover, Jr.  
Vice President of Finance and  
Chief Financial Officer

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