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Letter of Comment No: 5502
File Reference: 1102-100

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

Re: Proposed Statement of Financial Accounting Standards - Share-Based Payment

Dear Sir:

Texas Instruments Incorporated (TI) welcomes the opportunity to comment on the Proposed Statement of Financial Accounting Standard, *Share-Based Payment, an amendment of FASB Statements No. 123 and 95*. TI makes, markets and sells high-technology components and systems to more than 30,000 customers all over the world. The company has three separate business segments: 1) Semiconductor; 2) Sensors & Controls; and 3) Educational & Productivity Solutions. Semiconductor is by far the largest of these business segments. It accounted for 85 percent of TI's revenue in 2003, and over time it averages a higher growth rate than the other two business segments, although the semiconductor market is characterized by wide swings in growth rates from year to year. TI is among the five largest semiconductor companies in the world.

At TI, stock options are used primarily to... "recruit and retain skilled personnel, including technical, marketing, management and staff personnel. Experienced personnel in the electronics industry are in high demand and competition for their skills is intense." (from the 2003 Form 10-K *Risk Factors*). TI has over 34,000 employees world-wide and as of December 31, 2003, TI has granted, to a significant portion of those employees, over 228 million stock options and restricted stock units and has 1.7 billion shares of common stock outstanding.

As stated by our Chairman and CEO at the April 15, 2004 Annual Shareholders Meeting:

"TI is not opposed to the expensing of stock options. We believe options have value and that our stockholders should have a good understanding of that value and its impact to the company. What we oppose is a situation where TI unilaterally expenses options in the absence of common accounting standards that apply to all companies and are followed by all companies. Expensing in the absence of such standards would disadvantage TI's

stockholders by putting TI in a position unlike its competitors and most other companies. Further, it would make it very difficult to compare our financial performance with our peers' financial performance because each company would not be following the same standards and accounting procedures. The right way to expense is for the Financial Accounting Standards Board, known as FASB, to set a common standard that all companies in all industries follow.”

TI is also concerned with the measurement of the value of such payments and the effects on comparability between companies resulting from the variability in assumptions allowed by the proposed rules. As such, TI believes that, the methodologies used should be more clearly defined and applied on a consistent basis among all companies so that it results in the most equitable and understandable comparability between financial statements of various entities (specifically TI and its competitors).

As a result, the following comments will be limited to those issues raised in the Exposure Draft which we believe reflect our major concerns.

Specific Issues:

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations. Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

TI Response:

As noted above, stock options at TI are used primarily as a tool to recruit and retain skilled personnel. Stock options used at TI are almost totally non-performance based. The value to grantees comes at the end of the vesting period when they may exercise the options (if market prices are favorable), and regardless of whether the options have been exercised, the value to TI is that the objective of retaining the grantee as an employee of TI for that period of time has been achieved.

TI would also like to point out that despite the arguments to the contrary set forth in paragraph C13 of the Exposure Draft, TI believes the proposal to record compensation cost on the income statement is an exception to the normal accounting treatment given to expenses in that generally, assets and related expenses (even depreciation and amortization) reflect at some point in the business cycle that cash has been spent or a liability has been incurred. Compensation cost as proposed herein is a true noncash transaction and does not represent or create a past, present or future cash outflow and thus is not consistent with normal accounting treatment.

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

TI Response:

If the true intent of the proposed standard is to measure the value of the share-based payments given to employees, then on a theoretical basis, fair value should be measured at the grant date and then remeasured each period for changes in subsequent movements in the underlying market price of the stock. The initial fair value and subsequent remeasurements would be recognized over the remaining service period. As an alternative, measuring the fair value of share-based payments as of the grant date and recognizing it over the service period, as proposed in the Exposure Draft, would be acceptable.

Issue 4(a): In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate. Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model. Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

TI Response:

TI believes that the current Exposure Draft does not provide sufficient structured guidelines to ensure that the fair value measurement objective is applied with reasonable consistency. In the Exposure Draft, whatever option pricing model is used must take into account six factors, two of which are the most subjective and thus can cause the greatest diversity in application and therefore, valuation. These factors are the *expected term* of the option and *expected volatility* of the price of the underlying stock. For the expected term of the option, you must take into account both the contractual term and the *estimated effects of employees expected early exercise* and *expected post-vesting termination behavior*. The expected volatility of the underlying stock is determined for a period of time similar to the contractual term of the option and may factor out an “identifiable period of time in which the stock price was extraordinarily volatile because of a failed takeover bid or a major restructuring” (paragraph B25 (d)). In both factors, the Exposure

Draft does not allow using historical references without consideration of the impact that future experiences may result in differences from such historical perspectives, but it does not provide much guidance into how those future expected factors or experiences are to be determined. A significant investment in systems and administrative functions to track historical exercise and forfeiture patterns as well as other employee demographics will be necessary to meet the new proposed requirements.

TI believes that the assumptions used in these measurement calculations will have a bigger impact on the fair value calculation than the impact of which option pricing model is used. The current Exposure Draft provides too much leeway in the use of judgments for the assumptions used. TI believes that all factors used in the measurement of fair value of stock options should be more clearly defined and based on observable and auditable facts.

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. The Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options – they believe that a lattice model is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. The Board decided not to require the use of lattice model at this time. Do you agree with the Board’s conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board’s conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

TI Response:

TI does not believe that the current method as proposed in the Exposure Draft can accurately measure the fair value of employee stock options with sufficient reliability. The current guidelines are too loose and subject to variable interpretation and inconsistent application (see comments above on Issue 4(a)). There needs to be more structured guidelines applied to all companies to ensure comparability between companies.

TI does not agree with the Board’s conclusion that a lattice model is preferable. Recent studies made by some of the Big 4 accounting firms indicate little difference in valuations calculated by the two models when using similar assumptions. Although the use of the Black-Scholes model is well understood at TI, there are some theoretical limitations with its use. However, the use of a lattice model as currently proposed by the Exposure Draft will require the use of assumptions about early exercise behavior and post-vesting termination, as noted above, which are currently unavailable. To comply with the proposal, this will require the installation of costly systems and the addition of administrative functions to provide more detailed information on options and grantees

segregated into groups based on similar exercise behavior and employee demographics (e.g. salary level, marital status, age, job grade/level, etc.) Assumptions input into the valuation models would have to be updated to reflect newly documented experience (which will require time and effort to perform necessary analyses of that data). TI is concerned about the cost/benefit considerations of requiring the use of the lattice model when the most significant variables involved are subject to such costly analysis and then further subjective judgment must still be applied to determine if future expectations may materially differ from the historical perspective. By eliminating the subjectivity around the *expected term* and *expected volatility*, either option pricing model could then be used. TI recommends that ultimately one model be chosen to be used by all companies to calculate fair value. TI believes that this approach (mandating the use of one model for all) will further facilitate comparability between companies.

In the event the Exposure Draft is amended to mandate the use of a lattice model, TI recommends that the Board allow the continued use of the Black-Scholes option pricing model for a period of time while systems and information processes are developed to support transition to the lattice model.

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

TI Response:

TI recommends that the Board provide more specific guidance on the method to be used to determine volatility, including guidance on determining the future effects on expected volatility (see response above to Issue 4(a)). In addition, there should be no allowance to exclude selectable years of extraordinary volatility for the periods over which volatility is to be determined. Again, volatility factors should be based on observable and auditable facts. TI would prefer the Board prescribe a single source and/or process to use to determine volatility rather than allowing for subjectivity by reporting entity. TI does not believe a uniform volatility assumption for all companies would be appropriate.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant-

date fair value. For example, to take into account the nontransferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

TI Response:

TI recommends that the Board provide additional guidance on determining the future impact on expected terms (see response above to Issue 4(a)). Also, see response to Issue 4 (b) above for discussion of cost/benefit considerations related to systems and administrative functions needed for historical reference to develop the assumptions used to compute expected terms.

Issue 9: The Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

TI Response:

TI does not agree with the proposed method of treating each graded vesting layer as a separate tranche. This results in "front loading" of expense recognition, which is contrary to the intent of the Exposure Draft to recognize compensation expense for employee services received over the service period. Even though the value assigned to the employee's service is based on the value of the option, recognition of this front loaded expense implies that an employees services during the early periods are more valuable than later periods, when, in reality, the opposite may be true. An employee's value in the earlier years of a job is less than in later years due to the effects of the learning curve, etc. Therefore, recognition of employee service received should be based on a straight-line pro rata basis over the vesting period.

Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, *Share-based Payment*. Do you agree with the method of accounting for income taxes established by

this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer and why?

TI Response:

TI does not agree with the proposed method of accounting for income tax effects under the proposed Exposure Draft. TI believes the proposal would result in significant and potentially costly implementation issues and is an exception to the general principle of intraperiod tax allocation under FAS No. 109. Reflecting the complexities of the proposed model, companies will need to have a system in place to track at exercise, on an employee-by-employee and grant-by-grant basis, the amount of the actual tax deduction compared with the book deferred asset. Additional information, such as forfeitures before vesting and cancellation after vesting would also have to be tracked in detail.

TI recommends that all differences between tax and book deductions be recognized through paid in capital rather than the income statement.

TI recommends that, as an alternative, the current method of accounting for income tax effects under FAS 123 be required.

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

TI Response:

TI believes that the transition to the final standards should be applied on a prospective basis – applied only to new grants of stock options after the effective date. This will allow companies time to amend their compensation choices in light of the impact such choices may have on operating results.

TI believes that the use of the modified prospective method of transition will result in improper results being reported for the first few years of implementation as: (1) there is no provision for revaluing the nonvested portion of options granted in prior periods to a value consistent with the proposed Exposure Draft methodology; and (2) future periods should not be penalized for following applicable GAAP in prior years. Simply recognizing the old FAS 123 pro forma calculated valuations in current period expense will not provide consistent or comparable results when comparing to periods after implementation of this standard.

The former pro forma calculations of periods prior to implementation of this new standard would continue to be required to be disclosed in footnotes until the financial statements of all periods are presented on the new basis.

TI believes every company should be required to use the same transition method.

Issue 16: The Board decided that this proposed Statement would amend FASB Statement No. 95, *Statement of Cash Flows*, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid. Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

TI Response:

TI does not agree with the proposed requirement to record the excess tax benefits as a financing cash inflow but recommends that such benefits be consistent with the principles of FAS 95 that all tax activity be recorded through the operating section of the statement of cash flows. TI believes that excess tax benefits do not meet the definition of cash from financing activities in FAS 95 as such financing activities relate to transactions that a firm engages in to acquire and repay capital. The excess tax benefits from the exercise of stock options will ultimately be received from and associated with filings with the IRS, not from a stock broker, etc. Therefore such benefits should be classified as a part of operating activities.

Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

TI Response:

We applaud the efforts of the Board and its staff to produce a standard that can be useful and understandable, particularly with such a technically difficult and emotionally charged subject of stock options. However, we believe that there can be improvements in the comprehension level and general understandability of this standard if the provisions regarding the expected impacts of future events or behavior on valuation assumptions can be more clearly defined. Greater clarity and examples should be given as to how the Board expects reporting companies to determine these factors.

Unlisted Comments for Consideration – As the Board had indicated that it expects to issue final rules on share-based payments in the fourth quarter of 2004, which will leave little time for full and accurate implementation in the first quarter of 2005, TI requests that the Board consider delaying implementation of any final standard until the second half of 2005 or later.

TI would prefer that, if stock option expensing prevails, that such expense may be shown as a separate line item on the face of the income statement in order for investors and others to make any adjustments to their analyses for these noncash transactions. Further, TI would prefer that stock option expense be exempted from allocation of such costs to

individual business segment levels but rather be recorded in total in a General Corporate or Other category. This would allow TI to avoid further administrative complexities which would be created by employee movement, reorganizations, etc.

We appreciate the opportunity to present our comments to the Board. If you have any questions regarding this letter, please feel free to contact Rod Harden at (214) 480-1025.

Sincerely,

/s/ Charles R. Miller
Charles R. Miller
Vice-President and Controller