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**From:** Bob.Dykes@flextronics.com  
**Sent:** Wednesday, June 30, 2004 4:16 PM  
**To:** Director - FASB  
**Subject:** Director of Major Projects - File Reference No. 1102-100

**Letter of Comment No:** 5752  
**File Reference:** 1102-100

Attached are comments from Flextronics, in pdf format.

In case there is a problem with this file, the comments are repeated below:

June 30, 2004

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

Dear Sir:

This is to provide comments on the exposure draft concerning share based payments. For your background, Flextronics has annual revenues in excess of \$14 billion, with several thousand employees currently the recipients of stock options. On a forward looking basis, the expensing of stock options would reduce the profitability that would otherwise be reported by roughly one third. Thus, the expensing of stock options would be a very material element of Flextronics' reported profitability if FASB's proposals were implemented.

To summarize Flextronics' comments: We believe that most companies, investors, and other users of the financial statements will consider the expensing of stock options to be *an inappropriate item to include in the financial evaluation* of a company, and therefore most companies will eliminate it via the publication of "pro forma" results. On the other hand, if for some companies now, or over time, the expense is considered appropriate to include in the income statement, then the proposed rules *leave far too much room for substantial manipulation of the financial results* by way of management judgment that can not be controlled by External Auditors or the control process promulgated by the PCAOB.

More detailed comments on certain of the issues raised are as follows:

Issue 1: should stock-based compensation be recognized in the income statements?

Flextronics strongly believes that this item should NOT be recognized in the income statements, for the following reasons:

The first group of objections requires FASB to reflect on the purpose of Accounting. The proposed expensing of stock options *defeats most generally accepted reasons for companies having published financial statements.*

- 1) The measurement difficulties discussed later will result in expense elements that, based purely on management judgments, differ significantly between companies and over time. If investors were to actually refer to the resulting reported profits, it is likely that the results would be *substantially manipulated* by many companies, to the detriment of investors, in ways that could not be controlled by the External Auditors, nor SEC review processes, nor processes promulgated by the PCAOB under the Sarbanes Oxley Act. That is, profits calculated using this element as an expense would become generally *meaningless*.
- 2) For companies where the expenses are substantial, however, it is clear that “proforma” profitability that excludes option-expensing will be the primary means for investors to evaluate the financial performance of the company. Accounting rules that encourage the use of “proforma” accounting also result in *reduced control* of FASB, the SEC, and External Auditors, over the quality of the reported earnings.
- 3) Besides investors, financial statements are also used by other parties, in particular lenders. The non-cash nature of the stock option expense would lead to most lenders desiring to exclude it from key metrics, but then they will be relying on managements’ proforma accounting and would *not be able to rely on the formally published accounts*

The second group of objections reflects that the proposal is not in accord with general accounting theory:

- 4) There is *no liability created* or out of pocket cost to the company. This is necessary for an expense to be created under general accounting concepts.
- 5) Stock options may represent an opportunity cost to the company, but this would be the only opportunity cost that is accounted for anywhere in the financial statements.
- 6) The proposed expense will be based on substantial estimates that are never resolved. By comparison, pension costs, for example, although initially substantially based on assumptions, are eventually resolved to an actual expense, so that even substantially erroneous valuation assumptions are corrected over time. Option expensing assumptions will never be resolved to an actual expense and so the *accounting will remain permanently inaccurate*.

Issue 4 (a): Is the Fair Value Measurement Objective applied with Reasonable Consistency?

*No, the measurement will not be applied with consistency*, and alternative valuation methods that have been considered will not fix this. Nor will additional guidance. Examples of how inconsistency will easily be generated are:

- 1) Management will be required to provide judgments as to the likelihood and magnitude of dividends. At the volatility levels experienced by high technology companies, an assumption of a 5% future dividend rate, compared with no dividend, will reduce the option expense by about 25%. A 10% dividend rate can reduce the expense by over 40%. When the length of the stock option valuation period is considered, and given the magnitude of this assumption’s effect on the expense, this one judgment by management, that is not auditable, can change reported profits, in the case of Flextronics as an example, by 10% to 15%.
- 2) Similarly, management will be required to make judgments on likely changes in volatility, where the range of reasonable choices can easily affect the valuation by around 15%.
- 3) Judgments on the likely length options will be held and how options are grouped for this purpose, will also result in significant valuation changes.
- 4) The use of Black Scholes rather than the Lattice model method of calculating a valuation can also affect the valuation by up to 50%.

Thus, it is Flextronics’ opinion that management judgment, while honestly and reasonably applied, will easily affect option valuations by up to one half and thus, for companies where options constitute the same percentage of otherwise-reported profits as Flextronics, such judgments will be affecting reported profits by 20% to 30%, which displays that consistency between companies can not be achieved.

Issue 4 (b) Lattice model compared with Black Scholes

Flextronics notes that allowing companies to select the model used for valuation *exacerbates the inconsistencies* in valuations that will be produced.

Issue 14 (b) The Board claims that its proposal addresses a significant need and the cost of compliance is justifiable compared to the benefits. It then proposes that a more easily calculated method be used by private companies.

Flextronics believes that *these decisions and resulting proposals are not appropriate*, because:

- 1) Allowing different methods of accounting between private and public companies, and even between different private companies, will result in their results not being comparable.
- 2) The Board has *not shown that there is a significant need for the overall accounting proposal*, nor that there are sufficient economic benefits derived from the proposal, therefore the cost incurred by companies in compliance, and the cost incurred by investors and lenders when the reported financial results become meaningless, is not justified.
- 3) In particular, FASB justifies the change because it claims that existing accounting results in an inappropriate allocation of resources. Such a claim clearly suggests that FASB should be more open to hearing and understanding the objections raised by numerous parties based on the severe economic impact that the proposal will have, if investors actually believe the resulting reported profits.

Issue 18: Can the proposed accounting standard be read and understood?

Flextronics believes that the answer to this question is definitely NO. Because the standard leaves *too much room for substantial variation and manipulation in the resulting profits* that would be reported.

Thank-you for the opportunity to provide these comments. We urge the FASB to not proceed with the expensing of stock options.

Yours truly,

Robert R. Dykes  
Chief Financial Officer