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

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Dear Director,

I am a certified public accountant and the chief financial officer of Power Integrations, Inc. I am writing in response to the Exposure Draft concerning share-based payments.

I believe that the accounting and disclosure under FASB No. 123, Accounting for Stock-Based Compensation, is appropriate and does not need modification. This standard provides financial statement users with all of the necessary information. The financial statement impact from employee stock plans is already included through the treasury stock method used in the earnings per share calculation. Those few investors that are interested in option valuations have all of the required information in the notes to the financial statements.

Specifically, I will address Exposure Draft Issue 1 under the heading "Recognition of Compensation Cost" and Issue 4(b) under the heading "Fair Value Measurement". I believe that the expensing of stock options will make financial statements less useful and more confusing. The financial statements will not appropriately present the economic performance of a company. Financial statements could become irrelevant.

I have several concerns with the proposal to expense stock options. I have organized my comments under the following headings:

- Expense is nearly impossible to reasonably estimate
- Financial statements could become meaningless and irrelevant
- Treasury stock method appropriately considers dilution from stock options

### Expense is nearly impossible to reasonably estimate

Stock option expense is nearly impossible to accurately estimate. This difficulty is caused both by the nature of stock options and by the proposal that once the compensation amount is determined, it is not revised, even if information is available to the company that indicates the amount is incorrect.

None of the proposed valuation methods will provide a reasonable estimate of the value to employees and, therefore, the expense to the company. The value of compensation an employee receives should equal the expense recorded by the company. When an employee receives a paycheck, the employee's reported income equals the company's expense. Under the proposed valuation methods, the company must measure many historical factors, such as interest rates and stock volatility, to calculate a theoretical value of the stock option. However, due to the significant estimates required, it is highly unlikely that the value calculated by the company will approximate the actual value received by the employee. As an example, stock options granted to employees by Power Integrations in 1998 were valued at \$0.96 per share under the Black-Scholes method. To date, the actual gain received on those grants by employees has averaged \$21.21 per share. Therefore, the value received by employees was 22 times higher than the expense calculated under the Black-Scholes method. Conversely, many companies granted options prior to the stock market decline that had a very high Black-Scholes value, but will result in no value to the employees and no dilution to the stockholders, as the options are woefully "underwater". In each case, financial statements using Black-Scholes valuations had no relationship to actual transactions or economics.

To further illustrate the inherent problems with valuing stock options let's look at reported information from Power Integrations. In 1998, the company granted options that had a Black-Scholes value of \$0.96 per share. The options were granted with an average exercise price of \$5.08 per share. In 2003, granted options had a Black-Scholes value of \$15.52 per share. These options had an average exercise price of \$19.99 per share. Personally, I would much rather receive the options granted in 1998. However, the Black-Scholes method indicates that the 2003 grants had a value 15 times greater than the 1998 grants. There is a complete lack of alignment with economics in the Black-Scholes calculation and the binomial method is not significantly different. As a CFO, I could not easily explain why the per share values differ so greatly. The reason for the difference is not obvious and few financial statement users would understand.

In accounting for reserves and accruals a company will use both historical and forward-looking information. As an example, an inventory reserve calculation must use forward-looking information to be accurate. Historical sales trends are important, but the most important factors are those that relate to expected sales of products in inventory. A company will obtain input from the sales and marketing departments to estimate future sales of product in inventory. Based on this and other information, the company will establish reserves for items that cannot be sold at book value. Likewise, in establishing accruals, a company will analyze information to determine what it expects to pay in the future. The company does not merely look at what has been paid in the past and then

assume future amounts will be the same. Reasonably accurate forward-looking information is critical to these estimation processes. There is no forward-looking information to estimate the value of stock options, as nobody can predict the stock market. All that is available is historical information, which may not bear any relationship to the future. The valuation methods in the Exposure Draft rely exclusively on historical information to calculate the compensation amount. These methods are inconsistent with the estimating processes for all other accounting reserves and accruals.

In every area of accounting where estimates are used companies are required to continually update the estimates to ensure the financial statements reflect amounts based on the latest information. As an example, if after recording an inventory reserve a company determines that it cannot sell as much product as originally estimated it is required to adjust the reserve. Estimates are a “temporary” answer when transactions are not yet complete. Ultimately, the financial statements must reflect the actual transactions (e.g., inventory disposal). Under the proposed accounting in the Exposure Draft, companies would not be allowed to adjust the estimated compensation and, as such, the financial statements would never reflect the actual transactions. As a result, a company could be required to record compensation expense even when it knows, due to a dramatic decline in the company’s stock price, that there would be no dilution. Or a dramatic rise in stock price could have a company recording a small compensation expense even when employees have seen significant gains and investors have seen high dilution.

The combination of highly inaccurate estimates with no ability to adjust the estimates makes the stock option expense totally meaningless and useless. Financial statements would not reflect the ultimate economic substance of the transactions.

#### Financial statements could become meaningless and irrelevant

Many people already find financial statements difficult to understand. If stock options were expensed, financial statements would become much too complicated for the average investor or other financial statement user. Many companies, such as Power Integrations, could show consistent net losses, but have consistent positive cash flow. It would be much more difficult to compare companies. A company with a fundamentally stronger business might have worse financial statements merely because it has a more volatile stock price. Individuals would become more dependent on “sell-side” analysts to explain the financial strengths and weaknesses of a company. Every “sell-side” analyst I have spoken with has stated that they will exclude the stock option expense from their financial models. As such, the information investors use would become even more distant from GAAP accounting. It is difficult to find any users of financial statements that would benefit from including stock option expense. Even commercial banks would find GAAP financials irrelevant to their needs. Lastly, Management’s Discussion and Analysis (MD&A) in SEC reports would be very confusing. Management would need to separate “real” business changes from fluctuations caused by stock option expense. Again, the expensing of stock options would result in financial statements becoming less meaningful and nearly useless.

Treasury stock method appropriately considers dilution from stock options

The treasury stock method used in calculating earnings per share includes the impact to stockholders from stock options. The treasury stock method is appropriate since it automatically adjusts the dilution, or cost to stockholders, based on the company's stock price. As the stock price rises, employees receive more value and the stockholders receive more dilution. The cost to the stockholders is perfectly aligned with the value received by employees. The treasury stock method is relatively simple, it is well understood, and it reflects the true economics. Let's continue to use it.

Clearly, it does not make sense to require the expensing of stock options. Financial statements could become irrelevant due to highly inaccurate estimates, significantly increased complexity, and a lack of correlation to true business economics. Many institutional investors I have spoken with support expensing stock options merely as a method of reducing option grants. If stock options are expensed, they will adjust their financial models to reflect the true economics and their investment decisions will continue to be based on the current accounting guidelines. The negative impact from the proposed changes will be to individual investors and unsophisticated financial statement users. They will see overly complex and potentially misleading financial statements.

As a chief financial officer, I am particularly concerned about the proposed accounting in the Exposure Draft. I am required to certify Power Integrations financial statements in the Forms 10-K and 10-Q, subject to criminal penalties. Currently, I am comfortable certifying the financial statements, as I know they comply with GAAP and they appropriately reflect the company's economic results and status. If stock options were expensed, it would be very difficult to certify the financial statements, as it is not clear that they would reflect the economic substance of the company.

There are potentially very serious negative economic impacts from stock option expensing. However, I will not discuss those impacts in this letter. As I have stated above, from a pure accounting basis, it is inappropriate to expense stock options. I hope the FASB will reconsider its position. Thank you.

Sincerely,

John M. Cobb