Karen Salmansohn

Letter of Comment No: \\7 File Reference: 1102-001 Date Received: Z-1-03

From: Director - FASB

Sent: Monday, February 03, 2003 11:26 AM

To: Karen Salmansohn

Subject: FW: Invitation to Comment on Accounting for Stock Based Compensation (File Reference No.

1102-001)

----Original Message----

From: Crowley, Rick [mailto:Rick.Crowley@micrel.com]

Sent: Saturday, February 01, 2003 6:38 PM

To: Director - FASB

Subject: Invitation to Comment on Accounting for Stock Based Compensation (File Reference No. 1102-001)

Thank you for the opportunity to comment on the topic of accounting for stock based compensation and FAS 123. I strongly believe that the current United States Generally Accepted Accounting Principles associated with accounting for stock based compensation should be amended, specifically FAS 123

I realize that the Board is less interested in comments regarding the use of intrinsic value versus fair value accounting treatment for stock based compensation than other areas in its request for comment. However, while I agree that stock options do have value to the recipient at the time of issuance, the underlying transaction is fundamentally an equity transaction with an exchange of value between the option grant recipient and the shareholders of the enterprise. I believe this is adequately accounted for under current GAAP in the form of diluted earnings per share. Consequently, I do not believe the issuance of a stock option grant meets the criteria for an expense to the corporation at the time of issuance as put forth by FAS 123. The corporation has not divested of any asset, nor taken on an obligation that must be settled in cash or divestiture of an asset in the future.

If the FASB decides to retain the concept that the fair value of a stock option grant must be recognized in the financial statements of the issuing enterprise in the period of issuance, then a number of modifications should be made to the current methodology as put forth in FAS 123. These include changes to:

- . The method of determining the initial value of the stock options when issued by the enterprise
- The method of recognizing the stock based expense in the financial statements of the enterprise including;
 - o Elimination of the fixed rate amortization of deferred stock compensation expense over the vesting period of the option
 - o Implement recognition of stock based compensation expense in one of two ways. Either recognize the expense amount equal to the actual value realized by the option holder on the date of exercise. or expense the fair value of stock options issued in any given accounting period and then mark-tomarket the value of all outstanding options of the enterprise as of the reporting date, with the change in value of the outstanding options run through the income statement as a debit or credit.
 - o Report recognition of stock based option expense as part of comprehensive income similar to the change in fair value of financial instruments

The Black-Scholes option pricing model was developed to value relatively short-dated option contracts traded in the open market. Academic studies have shown the Black-Scholes ("B-S") pricing model does not accurately value employee stock option contracts, tending to overvalue the option contracts for a variety of reasons. Employee stock options tend to have a long life, e.g. 10 years, but restricted liquidity as a result of a vesting schedule and company enforced "blackout" periods where the option holders are constrained from exercising their options. The B-S model tends to overstate the value of the employee stock option due to the long contract life, and it makes no reduction in calculated value for the vesting period or periods when the option cannot be traded. In addition, the B-S model imputes value based on the current price of the underlying equity. The higher the market price, the higher the fair value and vice versa. The current accounting rules, utilizing the B-S model, do not accurately capture the underlying economics of an employee stock option. In fact, any economic value realized by an option holder is determined by the difference between the market price at the time of exercise and the strike price of the option. In addition, the employee option holder cannot trade their stock option in the open market to realize the fair value as determined by B-S. The employee can only realize the intrinsic value of the stock option, and then only when it is in the money! Some alternative to the B-S model must be investigated and allowed for use in calculation of fair value under any new accounting pronouncement if intrinsic value is not going to be used to determine compensation expense.

I believe the most important change that must be considered to the current accounting standard for stock based compensation is the elimination of the fixed amortization of the initial fair value of stock option grants. The current FAS 123 was developed as part of the move to fair value accounting. However, after beginning with a market based valuation model to establish fair value, the FAS 123 accounting methodology reverts to industrial age, fixed rate amortization to recognize expense in the income statement. In contrast, financial institutions that make a market in equity options compute the value of options frequently (sometimes on a real-time basis) and mark-tomarket the value of their portfolios in their financial statements per FAS 107, FAS 115, etc. If fair value is to be used to measure employee stock options on an enterprise's financial statement, the change in fair value must also be recognized. The rapid changes in equity values over the past five years have proven that expenses determined by FAS 123 fair value calculations do not accurately measure stock based compensation. When equity values were climbing in the late 1990's, the actual fair value of the options, (and the actual intrinsic value available to option holders), greatly exceeded the amortization of the initial fair value being amortized over the vesting period of the option. Likewise, the fair value of stock options granted when the NASDAQ market index was three times its current level, were computed to be quite valuable. In fact the fair value of most of those options today is substantially below the original computed value. Yet FAS 123 would have companies continue to amortize "compensation expense" that grossly overstates the both the real and computed value of those "underwater" option contracts. The accounting does not capture the economics. Virtually all other accounting for compensation expense accurately captures the value received by the compensated individual as an economic cost to the company as an expense. Clearly, FAS 123 does not accomplish this in its current form and must be modified.

If the FASB is going to use a fair value method for accounting for stock based compensation instead of intrinsic value then it should not stop half way. Fair value should be used at each reporting period with the fair value of new options expensed in the period granted, and the change in fair value of options granted in the previous period recognized in the financial statements for that period. The flaws in the B-S model mentioned above, together with changes in the market price of the underlying price of the company's stock, may cause significant fluctuations in the value of a company's portfolio outstanding stock option. There could be large "compensation" charges or credits in a company's income statement related to the change in computed fair value of the company's stock options. This is a natural consequence of using the fair value method of accounting. Others have presented arguments why such large swings in income statements from this treatment may be harmful or may cause the users of financial statements to disregard the stock based compensation expense. Nevertheless, the resulting fair value of the options would be much more accurately stated than under the current method. Once alternative for reporting could be to include the change in fair value as part of comprehensive income and minimize distortions to the income statement.

Once again I would like to thank the FASB for the opportunity to comment on this topic. Fundamentally I believe the current method of accounting for stock options using the intrinsic value method and diluted earnings per share, accurately accounts for the economics of employee stock options in the financial statements of an enterprise. However, should the FASB decide to implement fair value accounting for stock options, I ask that FASB consider the arguments and recommendations set forth above.

Sincerely, Richard Crowley Vice President, Finance Chief Financial Officer Micrel, Incorporated