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From: Art Whipple [aowhipple@quicklogic.com]

Sent: Monday, June 28, 2004 7:57 PM

To: Director - FASB

Cc: Carl Mills; David Peterson; Tom Hart

Subject: File Reference No. 1102-100



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June 28, 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

Letter of Comment No: 5443 File Reference: 1102-100

Via emai to: Director@fasb.org

Dear Sir,

QuickLogic Corporation is a small, public semiconductor company that grants employee stock options to all of our employees. About a third of our employees are located outside of the United States and approximately half of our revenues are earned from customers outside the United States. Our largest customer in 2003 was Chinese. Without stock options, it would have been much more expensive, probably prohibitively so, to recruit and retain our innovative employees who compete so well around the globe. However, we understand that the FASB is unlikely to consider the effect of the expensing of employee stock options on American competitiveness. We oppose the expensing of employee stock options because the economic effect of your plan will be the devastation of developing high tech companies. We also believe that the accounting mechanisms that have been proposed are flawed and we are providing our comments on your exposure draft. Some of the reasons for our opposition are as follows:

1. Stock options are not an expense.

The FASB issued Concepts Statement No. 6, Elements of Financial Statements, as a replacement for FASB Concepts Statement No. 3 which incorporated an amendment of FASB Concepts Statement No. 2). To my knowledge, this document has not been rescinded or disavowed. The following two paragraphs and their associated footnotes form the definition of an expense:

"Expenses

80. Expenses are outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, 42 rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations.

Characteristics of Expenses

81. 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. The assets that flow out or are used or the liabilities that are incurred 43 may be of various kinds*for example, units of product delivered or produced, employees' services used, kilowatt hours of electricity used to light an office building, or taxes on current income. Similarly, the transactions and events from which expenses arise and the expenses themselves are in many forms and are called by various names*for example, cost of goods sold, cost of services provided, depreciation, interest, rent, and salaries and

wages*depending on the kinds of operations involved and the way expenses are recognized.

Footnote 42--If manufactured products are accounted for at accumulated costs until sold, as is common in present practice, production costs are recognized as expenses in the periods in which product is sold rather than in periods in which assets are used to produce output. For example, use of raw materials and depreciation of factory machinery are included in the cost of product and are recognized as expenses as part of the cost of goods sold. In contrast, if products are accounted for at net realizable value using a percentage-of-completion method, as output under construction contracts often is, production costs such as raw materials used and depreciation of construction equipment are recognized as expenses in the periods in which the assets are used to produce output.

Footnote 43--In concept, most expenses decrease assets rather than increase liabilities. They involve using (sacrificing) goods or services, not acquiring them. However, acquisition and use of many goods or services may occur simultaneously or during the same period, and a convenient shortcut is often to record directly increases of liabilities (par. 79, footnote 40). Taxes and other expenses resulting from nonreciprocal transfers to other entities commonly do result directly from incurring liabilities."

There are no "actual or expected cash outflows (or the equivalent)" or "incurrances of liabilities" associated with the granting, vesting, exercising or expiring of an employee stock option. "In concept, most expenses decrease assets" and "involve using (sacrificing) goods or services." In this case, the only relevant "asset" is the market value of the shares of the corporation and that asset must increase (not be used or sacrificed) to provide any benefit to the employee. However, a company's market value is not an asset on its own balance sheet. Nor is there is "sacrificing" of goods or services. Options that are under water and expire unexercised are not of any value to employees. In-the-money options provide incentive for employees to perform and to remain in the employ of the corporation. If this could somehow be stretched to imply "(sacrificing) of goods or services", the sign would again be wrong.

There is clearly an element of compensation associated with employee stock options, but that compensation fails to comply with the definition of an expense. There are other examples of such compensation. An employee may accept a lower wage to work for a prominent or well-regarded company. Conceivably, the employer should find out if the prospective employee had an offer to work at another company at a higher wage. The difference between the two wages is compensation in the eyes of the employee, but the employer would not be allowed to gross-up a wage liability that would never be paid. Not every element of compensation is an expense.

In fact, an option more clearly represents dilution to existing shareholders not an expense to the company. If you determine that an "accounting entry" is necessary (since current standards provide for disclosing the dilutive effect of options in footnotes and earnings per share calculations), it is our opinion that it more properly is an equity entry. Perhaps a mark-to-market entry that is used to account for fair value of investments would better reflect the underlying nature of the stock option. This form of accounting would allow for fluctuations in market value. This seems more reasonable than recording an expense that is never reversed if the option is never exercised or if the market price declines well below the strike price of the option.

2. The proposed accounting for employee stock options grants is fundamentally inconsistent with the current accounting for restricted stock awards.

Companies use restricted stock awards to address some of the same compensation issues that employee stock options address. The immediate value of a restricted stock award is reasonably well known on the date of its issuance and that cost can be amortized to expense over the vesting period of the award. Ultimately, the market value of the shares underlying the restricted stock award will increase or decrease during the term of the award but these changes do not generate additional accounting entries. Whether the market price goes up or goes down, the amortization of the restricted stock award stays the same.

An employee who is granted an option to purchase the shares in the future must still pay today's price when he exercises in the future. The expensed cost in a restricted stock grant does not occur in this case. In the restricted stock case he is given the shares; in the option case, he must pay for them. Only the increase or decrease in market value provides the compensation element in an employee stock option. This is precisely the

value that is ignored in the accounting for restricted stock awards.

If it is your intention to estimate this future appreciation of the employee option, this thinking should also be addressed with regard to restricted stock awards. Doing one but not the other is inconsistent.

3. There is no reliable procedure for determining the value of an employee stock option at its date of grant.

There is no market for the "American style" options (variable exercise) that make up the bulk of employee stock options. The Black-Scholes equation gives people insight into the value of "European style" options (fixed exercise) and there is a robust market in these options. There are no "willing buyers and willing sellers" of American style options because no one can determine their worth. For the FASB to choose Black-Scholes, lattice or binomial algorithms without evidence that they represent an approximation of the ultimate value of the options is inappropriate. In addition, these models produce values for recording and expense that are more a function of the current market value of the underlying stock and its volatility rather than its value to employees or the company. Furthermore, they do not consider their real cost which is the dilution to existing shareholders.

Myron Scholes admits that the Black-Scholes model will not produce a meaningful result when applied to American style options. On Friday June 25, 2004, Mark Rubinstein, a finance professor at UC Berkeley's Haas School of Business who helped develop the so-called fair value method, was quoted in the San Francisco Chronicle as saying "I was one of the inventors of the (board-proposed) model, and I say: Don't use it. It doesn't work. Companies should have to expense only the amount that an employee profits after he exercises the option to buy the stock."

4. The value of the option is a function of the volatility of the underlying stock and the volatility is often impossible to estimate.

QuickLogic Corporation became a public company in 1999. QuickLogic does not have 10 years of historical data to validate a volatility estimate and such an estimate today would be worthless given the recent and unprecedented volatility of the semiconductor industry. The expensing of stock options would create a material increase in the company's compensation expense and this expense would attract the attention of and increase the effort expended by our auditors. Without a safe harbor for volatility estimates it is unlikely that a clean opinion could be rendered in the Sarbanes Oxley environment at any cost.

5. The cost of accounting for options under proposed rules will be onerous.

Most employee stock options provide for the vesting of options in small blocks over an extended time period. They also generally provide an extended time period of exercisability after the option is fully vested. Most of QuickLogic's employee options have 37 vesting events (25% at one year after grant and 36 equal monthly portions thereafter) during the term of the option. QuickLogic is a small company with about 160 employees, and most of our employees have about ten separate stock options. The concept of treating each vesting event as a separate option would create about 60,000 separate options (37 x 10 x 165). Scale this up to the 14 million employees with options and the cost to American industry will be enormous. The software tools to do this job don't exist. Public accounting firms do not have the capability to audit these calculations, but they are anxiously awaiting the millions of dollars of incremental consulting and auditing revenue that will accompany the expensing of stock options.

6. Use of estimates and contingencies

Under current accounting rules, companies record transactions involving estimates including allowances for doubtful accounts and reserves for inventory obsolescence. As additional information becomes available, companies are allowed to revise their estimates. As we have already noted, accounting for stock options involves a significant number of estimates including future stock prices, length of service for employees, and even the

ultimate exercise of the option. The exposure draft requires a company to record an expense during the vesting period of the option and once the option is fully vested, no changes to the estimated expense are allowed. This seems inconsistent with current practice especially since several of the determining factors will not be known until after the vesting period. In the worst case example, a company will record an expense and the employee will leave the company after the vesting period without exercising his or her options. In this case, the company recorded an expense and the employee received no benefit. However, under the exposure draft, the company is not allowed to adjust its estimate.

7. Accounting for contingencies

The exercise of an employee stock option is a contingent upon multiple factors including but not limited to 1) will the company remain in existence, 2) will the company's stock increase in price, and 3) will the employee remain in the employ of the company. Under FAS 5, contingent transactions are not recorded if they can not be reasonably estimated. As we have noted above, there is no well-established market or method for valuing employee stock options. Under this situation, FAS 5 would require disclosure in the notes to the financial statements. Current accounting pronouncements require such disclosure and companies today report factual information about outstanding options to investors and potential investors. This information, in our opinion, is adequate to allow each investor to make an informed investment decision about the dilutive effect of potentially exercisable options.

8. The expensing of stock options gives management a whole new way to "manage" earnings.

Since the option expense will be a function of strike price, volatility estimates, vesting schedules and expiration dates, management will have new tools to assign expense to various future periods. This will be used by unscrupulous management to hide seasonal variability, to make up for an otherwise poor quarter or to provide other imaginative ways to manipulate earnings in ways that don't show up as cumulative adjustments to assets and liabilities. Investors don't understand shareholders' equity today. They won't notice the funny business there in the future.

Thank you for the opportunity to comment.

Sincerely,

Arthur O. Whipple Vice President