

February 1, 2003

Financial Accounting Standards Board
MP&T Director – File Reference 1101-001
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Letter of Comment No: 214
File Reference: 1102-001
Date Received: 2-1-03

Re: Invitation to Comment on Accounting for Stock Options

Dear Sir or Madam:

Flextronics International is hereby providing its comments on the *Invitation to Comment* on accounting for stock options, dated November 18, 2002 (the “Invitation”). Because the proposed changes will have a **significant effect on the competitiveness** of companies raising capital in the U.S. public markets, compared with their Asian rivals, and because the changes will **substantially reduce the clarity and comparability of reported financial results**, we appreciate the opportunity to offer our insights.

We have examined the various option valuation models, and as discussed below, we have found no option-pricing model that will yield judgment-free, manipulation-free results that are comparable between companies. We believe that FASB should be concentrating its efforts on further improving the transparency of financial results. This proposal will take financial results in the opposite direction. Further, any form of expensing will reduce the perceived profitability of companies whose stock is traded on North American Stock Exchanges, and hence their ability to either attract talent (if they reduce options) or capital (if the retain options at present levels) will

be severely impacted by this proposal. We compete in a global market and our competitors, in particular **Asian competitors, will have a substantial talent-attracting and capital raising advantage** if U.S.-traded companies are hobbled by having mandatory expensing of options.

Executive Summary

Flextronics has 95,000 employees, up from 3,000 in January 1997 for a compounded growth in employment of 78%. Before this substantial growth started, it was the accepted wisdom that most manufacturing expertise was in Asia, and yet Flextronics and its North America competitors have been able to rebuild North American manufacturing competitiveness by attracting smart and hard-working engineers, technicians, and other professionals back into manufacturing. Further, we have been able to raise capital in the United States with strong earnings over an extended period of time. With the resources thus garnered, today we compete effectively with many companies from Japan, Taiwan, and the People's Republic of China.

Flextronics believes that the purpose of accounting rules is to ensure the transparency and comparability of financial results. It is very unfortunate, with all the recent events stemming from poor Corporate Governance, that FASB would continue with proposals that will aid those who wish to manipulate their results in the future. We urge FASB to instead concentrate on moving the accounting rules towards processes for which there is less judgment, less ambiguity, and more chance for uniformity between companies in a similar business.

Our specific issues with the proposal are:

- Mandated expensing of employee stock options is without reasonable accounting rationale.

- All the existing option pricing models, including Black-Scholes and binomial models, with the best judgment and adjustments, produce forecast results that have virtually no resemblance to actual results. These models were only designed to value freely tradable options. Mandated expensing will not improve financial statement transparency, comparability, or reliability.
- Stock Options are a capital event - - they potentially reallocate stock ownership. They don't change the absolute value of resources that the corporation has generated for its stockholders. There is substantial empirical economic evidence indicating that the use of broad-based stock option plans actually increase the value of resources created for stockholders.
- Expensing options is likely to lead to an even more distorted picture of a company's financial performance and condition. Mandated expensing will ensure that investors receive inaccurate and unreliable financial information that is highly subjective and easily manipulated.
- From surveys that have been performed by various entities, mandated expensing of employee stock options will eliminate broad-based stock option plans. Instead, they will be concentrated only on the more highly compensated employee group, such as management. North American companies will have to forego the productivity, innovation and economic growth generated by broad-based plans.

- As a general perspective on accounting rules, we urge FASB to enhance meaningful disclosures to help restore investor confidence. Meaningful, timely and investor-friendly disclosures that don't present sophisticated guesswork as reality is the best approach for accounting rules.

Value does not equal Cost

Those proposing the new rules do not seem to appreciate that Value and Cost are completely different in concept and substance. Simply looking at the many companies trading above their book value provides one indication that there is a difference. Furthermore, there are plenty of accounting rules associated with Acquisitions that address the premium value created by companies. While we can agree, therefore, that options have value to employees, even if we could reliably measure the value there is no direct link to the cost of the option. In fact, for most companies that issued options in the 1999-2000 period, the cost (in terms of dilution of other stockholders) of those options has thus far been zero, since most companies' stocks are trading well below the exercise values set in those years. With the layoffs that have incurred since those options were issued, many of the issued options never will have a cost. Yet the proposed mandatory expensing would include such option issuance as a cost to the corporation with no cost-recapture provision when the option is cancelled and no impact ever expected on the existing balance sheet of the corporation - - that is, no cash cost will ever be paid out by the corporation.

Although options do represent a benefit and value to employees, this is not sufficient reason to include it as an expense. For example, many employees take considerable value in working for

well-recognized name-brand companies. Others take value in working for a company located close to their home. It would be foolish to attempt to characterize all things that benefit employees as costs to the corporation.

The harm of unnecessarily burdening companies with fictitious costs

As explained in the previous section, we do not believe that Employee Stock Options should be considered a corporate cost. Adding such an expense to the income statement of companies that raise capital in the United States will represent a severe penalty. By comparison, Flextronics competes regularly with Taiwanese manufacturing companies, who are able to issue stock well below market value to their employees while taking no charge to earnings for such activity. A review of the financial performance of such companies shows that they generally have been using stock grants (issued at a nominal cost to the employee, well below market value) as the major means of compensating their executives. Taiwanese accounting rules do not require the expensing of these grants, and as a result, they are carrying virtually no costs on their income statements for their executives and senior managers. Never-the-less, they are able to raise capital at strong price/earnings ratios from what would represent, in North America, inflated profit levels. It would be very unfortunate if companies raising capital in the United States are further penalized by the mandatory expensing of stock options.

Capital Instrument versus Compensation.

A number of studies have shown that Employee Stock Options are much more akin to a capital event than a compensation event. Rutgers University Professors Joseph Blasi and

Douglas Kruse and *Business Week* Senior Editor Aaron Bernstein have recently documented clear empirical evidence that, contrary to the claims made by mandatory expensing advocates, employee stock options for non-executives are not compensation from an economic standpoint. They indicate that “*There’s substantial economic evidence that options bring workers capital rather than labor income*”. This should be no surprise, given that the widespread use of options began in Silicon Valley where public companies used options to compete for talent with the numerous Silicon Valley start-ups that enable new employees to invest, buying founding stock and working for below-market salary. Stock options not only align the interests of employees and investors, they make employees economic owners of the company. At the same time, the options they are granted do not represent a liability on the assets of the company. Thus, it is most reasonable to account for options as equity instruments whose sole accounting impact is to dilute the ownership of other investors.

Avoid Creating Another Way to Manipulate Earnings

With all the attention being paid to the poor corporate governance issues of recent years, it is extremely unfortunate that FASB is contemplating the introduction of mandatory expensing of stock options and thus introducing another means for corporations with ill-intent to manipulate their financial results. When the expense is based on one of the valuation models such as Black Scholes, it is highly dependent on assumptions such as volatility. Flextronics has had volatility in the range of 50 to 80 percent. A change of 10 points in the volatility assumption can change the “value” of the option by as much as 25%. Granting options when the stock price is temporarily depressed will also provide a lower measured value, while most employees would

see such an action as providing an option with a higher value. Opportunities also exist to manipulate the valuation models with changes in option lives and various option-exercise pricing methods. Further, the adoption of mandatory expensing of options will be **yet another reason why companies will want to report, and investors will want to see, “pro-forma” earnings** that exclude this non-cash expense. With the fictitious impact on retained earnings, which could be substantial for Flextronics, credit ratios will be materially affected and so rating agencies and banks may also have to adjust the reported U.S. GAAP results to have financials that are useful to them. It is unfortunate that FASB proposes promulgating rules for expenses that investors do not want to see in the financial results.

Conclusion

Any expense computed using current option pricing models will disproportionately impact companies in highly volatile industries as well as those whose employees benefit from broad-based stock option plans. Such companies have been the drivers of economic growth in this country over the past 10 years. Mandatory expensing will reduce the competitiveness of North American companies compared to their Asian competitors. The true cost of options is borne by shareholders who only take the resultant dilution as their stock values appreciate. There is no actual cost incurred by the corporation itself.

Mandatory expensing will reduce the transparency of financial results, encouraging and abetting numerous activities to manipulate the results. It will further encourage the use of “Proforma” presentation of financial results.

We strongly urge the Board and the IASB to devote the time and resources necessary to focus on disclosure of relevant, comparable, and meaningful financial information. This will

much better serve investors, better facilitate capital formation and economic growth, and improve the standing of generally accepted accounting principles as the measure of financial return.

Thank you for considering our views.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert R. Dykes". The signature is fluid and cursive, with the first name "Robert" being the most prominent part.

Robert R. Dykes
President, Systems Group & Chief Financial Officer
Flextronics