

Stacey Sutay

Subject: FW: Stock Option Expensing

Letter of Comment No: 116
File Reference: 1101-SCU
Date Received: 11/13/03



Expensing Stock Options in a R...
InterScan_SafeSta mp.txt (338 B...

-----Original Message-----

From: Sharp, Steve TQO [mailto:ssharp@tqs.com]
Sent: Thursday, November 13, 2003 4:25 PM
To: Michael Tovey
Subject: Stock Option Expensing

It was suggested by several people that I should send this to you and you would send copies to the FASE members. I would appreciate the help. My contact information is below if I can be of any help. Thank you.
<<Expensing Stock Options in a Responsible Fashion.doc>>

Best regards,
Steve Sharp
Chairman of Board
TriQuint Semiconductor
Ph. 503-615-9408
Fax 503-615-8901

Expensing Stock Options in a Responsible Fashion

The stock market bubble in the late twentieth century created great wealth for some executives and some investors who sold out early. But it also crushed expectations of many individuals as the stock market tumbled. Most people felt the disappointment of a lifetime as they saw their saving drop precipitously. This caused public resentment of the winners (a few) by the losers (the many). People wanted to blame someone.

The discovery of a few CEOs who were using their corporate assets for their own means or reaping huge gains from selling their options or settling termination agreements with enormous payoffs were an easy target for public bashing. Somehow, this bashing turned to executive stock options as the villain. The answer was to find an expensive way of expensing these options as a way to punish those guilty and prevent the problem from happening. No one considered the impact on our economic system or the many employees who have options who did nothing wrong.

Let's all admit that there were big winners and losers due to the rise and fall of the market. Thousands of jobs were created and then destroyed. Trillions of dollars of private investments ballooned and then tumbled. Let's all also admit that although there were a small number of CEOs or other executives who "lied, cheated, and/or stole," this was such a small number of people that it was a small exception and not the rule. Most executives would never risk their careers in an environment transparent to many employees who could easily report them to the Board of Directors. Yes, there are some thieves in the world and some happen to be in business. If guilty, put them in jail.

Let's also examine the positive effects of stock options. Stock options have been the driver for the entire technology industry for over 30 years. This is simply looked at as a sharing of the equity created by the investors and employees. Employees make no money unless the stock goes up. If it goes up, the employees get the gains commensurate with the investors, as determined by the Board of Directors, elected by the investors. The Board has to determine if the investors would gain more by the granting of options than is given up in earnings dilution. Clearly this worked. Almost all companies gave options to almost all employees. Today about 85% of the technology public companies give options to employees; and employees who are not executive officers of the company hold about 65% of all options. Such great companies as Microsoft, Intel, Applied Materials, Dell, and Cisco were created through the use of options to attract the best and brightest people and motivate them to work together. If they beat their competitors in the market, their company's stock goes up at a greater rate than their competitors. There are huge competitive forces. This drives productivity and innovation increases and lowers costs. This is a very exciting experience and draws management, employees, investors and customers into a win-win solution. This sector of the economy was far and away the fastest growing portion of the manufacturing jobs in America and millions of jobs in other sectors such as housing, food and services, were created through the multiplier affect. The Europeans, who have had many restrictions on options put by their socialistic systems and political processes, have been much less successful in these sectors than America. In Asia, companies are rapidly becoming competitive with our technology

industries. Asian governments are encouraging the use of options and companies are using them to drive success just as we have done in America. Countries like China, Taiwan, Korea and India are quickly turning to the use of options. America cannot afford to give up the use of options to employees. Every American should fear the repercussions of a death to the driver of our most successful manufacturing sector. If options go away, the sector will no longer attract and unite the people to compete with the foreign countries. These countries covet the new and emerging markets such as biomedical and new consumer electronic applications, and want to capture, through innovation, those markets such as computers, software, semiconductors, and telecommunication systems which we have pioneered and developed.

Nevertheless, the Financial Accounting Standards Board (FASB) is attempting to create a political solution to the problem of executive compensation by forcing companies to expense stock options. This was not done in the past because options were viewed as an equity transaction only and accounted for by calculating the effective number of shares in the vested options and using this to calculate the earnings per share. It appears that FASB is biased to try to come up with as large a number as possible because instead of simply finding a way to calculate a "cost" to the company of giving the option, they are trying to force a solution that calculates a "fair value" of an option, which is of course much larger than the "cost" of the option. Many years ago FASB adopted the requirement that all public companies should report in the perspective the "Black-Sholes" value of the options in the footnotes of the company financial statements. This is a complicated formula that imputes a value for options based on history. This method was developed by economist to model the behavior of securities over a short period of time that were freely traded, not at all appropriate as a model for the long term value of options that companies give to employees. This effort was a complete failure as the results were known to be irrelevant and although companies have published them for several years, investors and stock analyst have universally ignored the information. FASB first wanted to use this method, and then tried to change to a "new" Binomial method to calculate fair value. When that suffered the same flawed rationale as the Black Sholes method, they now are attempting to force another solution. This solution appears to value the spread in market value to option strike price at the beginning of each year when the options vest to calculate the value of the options vested that year. The company is forced to expense this through compensation expense on the profit and loss statement. This means that companies will either have to give options that vest in the year of grant or suffer huge unknowns as to the "fair value" of the options they gave. The more successful a company is in creating shareholder value, the more it would be punished by the "fair value" created on the P&L. This is only one of the arguments against creating such a new ruling. It does not stop executive options; it is more likely to stop employee options. If you talk to professionals in the accounting industry, they believe FASB's position of trying to calculate "fair value" is wrong from an accounting perspective and motivated politically. It appears that the major accounting firms who are represented on FASB are all afraid of backlash to the accounting industry unless they find a way to expense a large amount on options and stop their effective use. After all was it not the Accounting firms that helped cause the Enrons, the Tycos and the Worldcoms ? Does everyone remember Arthur Andersen? Accountants are now expected to redeem themselves for letting that happen. Again public

opinion being driven by the press and past events is about to create an atrocity that will damage for years to come our best chance of world competition.

Let's look closely at the expense of a stock option from a company perspective. An option gives the recipient the right to buy the stock at a fixed price, usually the market price at the date of grant of the option, after he has vested (or earned this right by employment) it for a fixed of time. Usually vesting takes place over 4 years and the option expires after ten years. Employees are motivated to stay with the company and hold the stock and collect the money over a long period of time.

Here is a rational alternative; there is an imputed cost of the company granting this option. The company could have sold the stock at the grant date and put it in the bank and drawn interest. Because the stock may never actually be issued, for example the stock may fall, the money should be viewed as having to stay in the bank. This means that the cost to the company of having an option outstanding is the cost lost by not having the money in the bank for the duration of the option being outstanding. There is an interest rate that very closely approximates what most companies earn on their bank deposit; it is the Federal Fund Rate. If this rate were used to calculate the cost of options then it would be easily available to everyone and the results of one company would be easily comparable to another. The cost of options would be an interest expense, calculated by summing all outstanding option grant values (number of shares times market value on date of option grant) by the Federal Funds Rates at the grant date. Once the option is exercised or cancelled or expired, the imputed cost would stop. I believe that if this method were adopted, companies would also start to put provisions in the option agreement that if the stock fell to say 50% of the initial value the option would automatically be cancelled, even if vested. This would acknowledge that the stock was not an unconditional right and motivate employees to not have the stock drop. It would also acknowledge that if it did happen, the employees should be re-incident, not left in a hopeless situation. This is much more advantageous to investors than to have management decide when to trade stock options for lower priced ones. This total method is a huge advantage to investors who want to understand what is the cost of options between different companies. The expense of options would be easy to report for corporations. As interest expense it would not be used in the calculation of operating income because it is not a cost of operating. Companies would still be judged on their performance in earning money from operations. We must view the issue as one of determining what creates the value and what is the cost of money. After all it is the employees working together as a company that created the increased value of the stock, not the investor who just invested the money. Investing never created "added value", it created opportunity for employees to add value.

Let's not stop at the point of determining a way to calculate cost of options; Let's look at the real world application of this method and the implications. I will use TriQuint Semiconductor as an example and discuss the variants for other companies or industries. In looking at the present sales level and long-term indices for performance metrics, I have estimated and expenses of options and used those in calculations of relevant metrics for investors. TriQuint has a sales run-rate of about \$300M per year, a market cap of \$1B and

has an enterprise value of \$800M. Payroll is about 33% of sales; long term the operating income has been an average of 15%. There is an overhang in options (total outstanding options amounting ratio to the total stock outstanding) of about 15% on average. The Federal Funds rate was about 2% over the last 4 years. If you calculate the imputed cost of options assuming these conditions and assuming that all options are at market, then the expense is about \$3M per year. This amounts to about 3% of payroll, 6.7% of operating income, 1% of revenue or 0.4% of enterprise value. Clearly a benefit that is 3% of employee income is meaningful but not excessive from a human resource perspective. Although it is 6.7% of operating income, from the investor perspective, it does not drastically change the investor's perspective on performance. And clearly it is little consequence from the total enterprise perspective. In my experience these seem to be numbers that most people would think are reasonable. They are so because they are derived from the actual way we think about options before we grant them. If you view them from a broader perspective, you can also quickly calculate what the expense would be for other companies as well. If I ignore the bottom 10% and the top 10% on these metrics in high tech for the parameters, I believe most companies would fall into the following ranges of values (Poor vs. Good Performing Company): Enterprise value to market cap (.5-1.5), Market cap to sales (1.5-8), Payroll to Sales ratio (40%-20%), Operating Income to sales (5%-30%), Options outstanding to shares outstanding ratio (20%-8%). If these are used and all worst case (Poor Performance) and best case conditions applied (Good Performance), I believe the ranges for expense as a percent of payroll would be from about 1.5%(Poor performance) to as high as 25%(Good performance); expense as a percent of operating income would be from 12%(Poor) to 17%(Good); expense as a percent of enterprise value would be from 0.8%(Poor) to 0.4%(Good); and expense as a percent of sales would be from 0.6%(Poor) to 5%(Good).

What is also equally important in the system level look at this approach is to reflect on the motivation that it creates. Companies that are producing exemplary results will have rising stock values. Since stock is given yearly to employees, these companies will have a lower expense in relationship to the market cap so will be able to give employees a greater number of shares. Companies performing less admirably will receive pressure to keep the expenses lower and give fewer shares until they can improve the performance. This is in the interest of investors and is motivational for the employees. Bigger more stable companies will find it difficult to grant as many options when their growth rate and stock escalation wanes, but of course that is the time they will be creating fewer new jobs. Younger, more aggressive companies will continue to be able to grant options as they grow and create jobs. Again, this is a practical answer from an investor perspective. High tech companies that can learn to be successful with fewer employees per sales dollar such as fabless semiconductor companies will be able to give more shares per employee than those companies who do not accomplish this leverage. Again, this model fits our common sense model from the investor perspective. Fewer key employees can make a bigger impact on earnings; therefore give them more motivation.

I would encourage all executives to calculate these numbers for your company. I believe you will find the expense will seem reasonable if considered an interest expense and a justifiable expense. I would encourage investment analysts to investigate it for the

companies they follow and determine if the information would be fair and valuable. I would encourage investors to compare a few companies in their portfolio and see if they think the information would be relevant and valuable. Another great advantage of having an option system accounted for in this way is to have consistency and comparability between companies. This simple technique provides that. In no way do the methods proposed by FASB. I ask all accountants to examine the technique to see if they can improve on the method as a way of determining the "cost" to the company of options. That should be what is at issue, not what the "fair value" might be based contrived formulas. The real value of the options depends what the stock market puts on the stock in the future. That depends on how well the options work to motivate the employees. You cannot separate the value created by the employees unless you just take out the cost of money for the options.

Recently the bubble and crash in the technology market has given us mandatory approval of option programs by all investors, new regulations of oversight by Sarbanes Oxley, new disclosures in public documents. These although extreme to many people in breadth, have done much to send a strong message to companies to not cross and lines of trust. Unless the direction changes on the FASB proposals the economy as a whole could be threatened like nothing we have ever seen before.