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From:

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President, Chief Executive Officer
and Chairman of the Board
On behalf of the Board and management of
Maxim Integrated Products, Inc.

We wish to thank the Financial Accounting Standards Board (FASB) for the opportunity to comment on accounting for stock options. We understand that the FASB's Invitation to Comment poses a specific list of issues that are intended to spur discussion on the similarities and differences between the existing rules embodied in SFAS Number 123 *Accounting for Stock-Based Compensation* and the IASB proposed IFRS *Share-based Payment*. We believe that the differences in opinion on this topic that have resulted in the issuance of the Invitation to Comment highlight some of the fundamental difficulties that are encountered when trying to fit the granting of employee stock options into the expenditure-based expense paradigm of our present accounting system. We consider this a very important issue and welcome the opportunity to comment on the topic of expensing options.

In reviewing the Issues for Respondents in Appendix B to the Invitation to Comment we are struck by the arcane issues that arise when two separate highly trained and experienced accounting standard setting committees apply their intellect and creativity to try to accomplish the futile task of measuring an inherently unmeasurable quantity, specifically the value that every individual employee places on the right to acquire shares of stock at today's price at an unknown future date that can fall many years in the future.

We have six years of experience in using a model to attempt to place a value on employee options and in the process have placed a value on these options that we feel is neither real nor useful. As do most other American companies that issue employee options, since adoption of SFAS No. 123, the notes to every Maxim audited financial statement have presented a Black-Scholes calculation of the cost of the corporation's option grants, together with the hypothetical reduction in earnings and earnings per share. Maxim has presented that information, not because we believe it is useful, but because it is mandated. The problems with this model, problems which we believe are inherent in the use of any model to arrive at a value for options, are discussed below.

The Black-Scholes option pricing model was developed twenty years ago for the purpose of pricing short term publicly traded (liquid) options and warrants. It was not designed to value employee stock options. Black-Scholes depends on a number of subjective

assumptions relating to volatility, risk-free interest rate, dividends, and option duration. This means that even small errors in these independent variables can produce a significant error in the final result. As a consequence, the reliability of Black-Scholes, even for the purpose for which it was created, is not empirically supported in the case of options of longer duration where the variables may change over time.

Moreover, it is essential to recognize that employee options are fundamentally different from traded options in many respects. The following factors, among others, would diminish the value of employee options relative to traded options:

- The option is given to the employee on a very conditional basis and is often returned to the company.
- Employee options are typically not exercisable for months or years after grant because of vesting terms.
- To the extent not vested, employee options must be forfeited upon termination of employment, and are not passed on to heirs in the event of an employee's death.
- Employee options are non-transferable under the terms of the grant.
- Typically, after exercise of employee options, for all officers and many other employees the resulting shares are not saleable on many of the trading days of the year because of insider trading "black-out" period during which trading in company stock is prohibited.
- Vested employee options must be exercised, potentially prematurely, within a brief period following termination of employment, with this brief period made even more constrained if the employee is subject to the black-out restriction mentioned above.
- Unlike traded options, which, if held for more than a year, are accorded capital gains treatment (20% maximum federal rate), employee options typically result in ordinary income taxed at more than two times the capital gains rate (federal tax at a maximum rate of 38.6% plus payroll taxes of more than 1.5%).
- The holder of a traded option can, and usually does, realize value by trading in the option itself and places no further cash at risk. The holder of an employee option can only realize value by exercising the option. This subjects the holder of the employee option to the financial risk of exercising, paying taxes at that time, and realizing financial loss on the acquired stock if the price falls.

Assuming for purposes of argument that an option pricing model could be relied upon to produce an accurate value for a *freely-tradable* option, it should be obvious that the result obtained by the standard calculation would have to be discounted -- possibly drastically -- if the goal were to calculate what a willing buyer would pay for an employee option in an arm's length transaction.

But the existing rules of SFAS No. 123 do not permit discounts that could take into account the foregoing fundamental differences between traded options and illiquid, severely conditional and restricted employee options. The reason as stated in the SFAS No. 123 Basis

for Conclusions is such discounts would not be objectively determinable. Nevertheless, the use of a valuation model such as Black-Scholes is significantly impacted by projected holding periods, volatility, etc. that also involve subjective assumptions. Given that no arm's length buyer would conceive of paying the same amount for an employee option that he would pay for a tradable option, we submit that forbidding application of the discounts that any rational buyer would require renders the resulting valuation essentially arbitrary. We note that unlike the FASB, the SEC permits such discounts in its rules relating to proxy statement disclosure of option values based on Black-Scholes or similar calculations.

The FASB is correct, however, that the existence of subjective factors in the Black-Scholes calculation together with the imposition of multiple discounts would mean that different companies selecting different assumptions and discount factors will almost certainly end with significantly non-comparable financials. Of course, comparability of financial statements is critically important to the investor. For those reasons, Maxim believes that the Black-Scholes model or, for that matter, any option pricing model, does not provide a reliable measure of the value of employee options and cannot be used to achieve the goals of credibility and comparability of financial statements. Maxim believes this view is widely shared by investors and responsible accountants and economists.

Here is a concrete example of how distorting the use of a model (in this case Black-Scholes) can be. At Maxim today we have employees holding options that will vest in fiscal 2003 with exercise prices, for example, of about \$7.50 and \$87 (compared to a closing price of approximately \$32 on January 27, 2003). Suppose one employee has an option under which 1,000 shares becomes exercisable this year at the \$7.50 price (well in-the-money) and another has an option with the same number of shares that also become exercisable this year at the high end of \$87. If Black-Scholes had been applied as proposed, there would be a charge to Maxim earnings in fiscal 2003 of approximately \$5,000 for one of these options and \$53,000 for the other. If your intuition said the higher charge was associated with the option that in fact has some intrinsic value today, your intuition would be wrong. The \$5,000 charge is for the now in-the-money \$7.50 option, and the \$53,000 charge is for the currently far, far out-of-the-money \$87 option. In our opinion this would be a gross distortion of reality. This situation is by no means an isolated case – it is repeated across the spectrum of companies that have granted options to employees during the past decade.

Following the same example, some of the \$87 options described in the above paragraph have already been cancelled because the optionee terminated employment. Under the rules of SFAS No. 123, a significant portion of the \$53 per share value assigned to these options would have been amortized as a charge against earnings. This is true even though the option never vested, was never exercised, never produced a gain for the optionee, and never produced a tax deduction for the Company. How can an accounting rule that produces such anomalous results serve the interests of the stockholders?

Even those few U. S. corporations that have decided to expense options cannot agree on how to value option grants. A variety of valuation schemes have been proposed. Coca Cola, for example, has announced that it will deduct a value for stock option grants as part of compensation expense. However, Coca Cola does not agree that use of an option pricing model

produces a “real” result and has described a completely different approach to valuation. The reason for this, presumably, is that Coca Cola believes that use of a model to value options produces flawed results.

An issue posed by the accounting boards is whether to prescribe use of a specific model for valuing options. The rationale behind this suggestion indicates the lengths the boards are willing to go to achieve comparability among enterprises. It is disconcerting to consider that operating results that are in every other way reported with rigor and precision will be mingled with significant charges that result from the “make-believe” results of a broad valuation model. The logic is that, albeit arbitrary, use of a standard model to arrive at an expense related to the grant for options achieves better comparability. The result, however, is to load into the financial statements a significant, arbitrary, and unrepresentative non-cash expense which degrades the usefulness of the financial statements. The income statement as presently designed reports items of revenue and expense that are in virtually all cases able to be diligently and rigorously measured and tabulated. Even such classic non-cash expenses such as depreciation tie directly back to a measurable cash expenditure. The very fact that the accounting boards are discussing their willingness to sacrifice accuracy and precision in the preparation of this statement for the sake of comparability is, in our opinion, an indictment of the fundamental concept of mandating the inclusion of significant non-cash expenses into reported earnings.

The impact of loading non-cash expenses into the income statement can be illustrated by this example. If options are expensed, i.e., charged against earnings, that expense will also be a reduction in net worth. This creates an anomaly in the balance sheet which on its face seems inconsistent with sound accounting principles. Suppose Corporation A, having \$10 million in cash as its sole asset and no liabilities, hires Employee B to use the Corporation's \$10 million of cash to buy a tanker of oil for the purpose of reselling it at a profit. Because B is a talented person with excellent skills in marketing oil, the shareholders of Corporation A agree to share their profits with B in the form of a stock option to purchase 33% of the corporation's equity for \$5 million cash. Suppose this option is valued under option-expensing accounting rules at \$3 million. Assume now that Employee B arranges the sale of the tanker of oil for \$20 million (net of transaction costs). The income statement would show revenues of \$20 million, cost-of-goods sold of \$10 million, expenses of \$3 million on account of the employee option and a profit of \$7 million (ignoring taxes). The retained earnings of Corp A are stated at \$7 million, yet the business earned \$10 million on the sale. Where did the other \$3 million go? The non-cash expense has distorted the reported results that are intended, after all, to inform the owners how their business operation has fared, and has had the effect of masking the free cash flows of the enterprise.

In this illustration, the \$3 million expense means that the retained earnings reported in the balance sheet will not agree with the economic reality that the corporation earned \$10 million in cash. Some economists, accountants or others might argue that the expense is real because at the time of grant the potential for gain embodied in the option had value to the employee whether or not the option did in fact end up having real value. However, value to the employee is not the same as cost to the corporation. The cost, if any, is borne by the owners of the corporation, not the corporation itself.

The distortion caused by the option expensing process carries over into other regions of the balance sheet. SFAS No. 123 will have a company record capital where no capital was received. Today, on Maxim's Statement of Stockholders' Equity, every penny recorded as an addition to Paid In Capital can be traced back to either hard cash paid to the company for the issuance of shares, or hard tax savings realized attributable to the option deduction on the corporate income tax return. The expensing schemes will have the effect of causing companies to record vast amounts of hypothetical capital contributions that were never received. We fail to comprehend how the investor community is served by this distortion of the balance sheet.

We believe the treasury stock method for determining the impact of employee stock options is entirely adequate for the task. The inherent strength of this method is that its formula faithfully measures the dilution caused by options only when they are in-the-money and therefore adding to dilution. The more the options are in-the-money the greater the dilution of the option program and vice versa. This, of course, addresses the fundamental problem with the use of valuation models that assign a value to an unvested fair-market-value option grant on the very date of grant even though there is no immediate cost associated with the option. In fact, unless the stock price increases *and* the option vests, there will never be an economic value associated with the option.

The treasury stock method computes with precision how much earnings the existing owners have given up in favor of the option-holders. Indeed, the difference between basic and diluted earnings per share, taken times the number of shares outstanding, is readily translated into an expense equivalent that represents the impact of the option program on the enterprise. In Maxim's fiscal year ended June 29, 2002, the difference between basic EPS (\$0.80) and diluted EPS (\$0.73) was \$0.07. The calculation of the compensation cost of employee options, therefore, is as follows: the dilution in net income per share of \$0.07 per share is multiplied times the number of diluted shares outstanding (355,821,000), which results in \$24.9 million at the net income line. Since compensation is a pre-tax cost, the correct measure then is the \$24.9 million adjusted by Maxim's tax rate of 33% (i.e., divide the \$24.9 million by 1 minus 0.33, or 0.67) resulting in \$37.2 million of imputed compensation cost in fiscal 2002 from employee option grants. This represented approximately 3.6% of revenue for the year. In the interest of creating greater transparency to the impact of options on reported earnings, we recommend that the FASB consider requiring inclusion of the amount of earnings transferred from the existing shareholders to the option-holders on the face of the income statement as a component of the earnings per share presentation.

We recognize that an economist might argue that analytically there is some value, however small, in an unvested out-of-the-money option on the date of grant. We can't disagree with that point. Somewhere there would be a willing buyer who would pay something for that option. However, it seems to us that the problem we are dealing with is not an academic economics one, but a practical accounting issue. Absent a true market for employee options, with bona-fide buyers and sellers acting in real time and with real money, we cannot know the value of such grants. Any attempt to assign a value is arbitrary and adds uncertainty to the process of reporting earnings that are truly representative of how a business has performed.

Given the contingencies affecting valuation – the necessity that the stock increase in value after the grant date and the option be earned by the employee over a period of years and the other factors discussed above – it is clear to us that there is no “readily ascertainable fair market value” (to use a phrase from the Internal Revenue Code) for an employee stock option. Even the Internal Revenue Service, hungry as it is for revenue, foregoes taxation of employees when they receive option grants. Their regulations specify that an employee option grant does not have a readily ascertainable fair market value “unless the option is actively traded on an established market” or “unless its fair market value can otherwise be measured with reasonable accuracy.” It is basic tax law that employee options like ours do not meet these requirements. It is certainly no more acceptable from an accounting point of view to assign values to employee options in the absence of the ability to measure value “with reasonable accuracy.” In our opinion, to do so would be inconsistent with basic accounting principles.

The issuance of a stock option is fundamentally a transaction between the shareholders and the employee, in which the shareholders agree, under certain conditions, to share their profits in the corporation with the employee. The effect of this sharing arrangement is shown clearly and precisely in the earnings per share calculations, i.e., in the difference between the basic and diluted earnings per share. Granting of options is done completely outside the context of the operations of the business and therefore should not appear on the profit and loss statement other than as a component of diluted earnings per share. Employee options represent an agreement by which the present owners of a corporation share their ownership interest with the workers in order to create value for both. To use a dubious model to invent a hypothetical expense to charge against earnings frustrates the objective of reporting earnings that are comparable and transparent. The concept of an implicit contract between the shareholders and the employee is essential to the option grant. Accordingly, we endorse and recommend that the FASB consider adding a requirement that shareholder approval of shares made available for option grants be obtained as a pre-condition for companies to continue to report options under the intrinsic value method. We believe shareholders will be much better served by this change than by an expense method whereby a large and unpredictable distortion of the income statement is the natural result of forcing an equity transaction through reported earnings.

Sincerely,

John F. Gifford
President, Chief Executive Officer
and Chairman of the Board
Maxim Integrated Products, Inc.