

Karen Salmansohn

From: Director - F
Sent: Tuesday, F
To: Karen Salm
Subject: FW: Respc

Letter of Comment No: 288
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-----Original Message-----
From: Michael Roe [mailto:michael.roe@qlogic.com]
Sent: Friday, February 14, 2003 5:06 PM
To: Director - FASB
Cc: Frank Calderoni
Subject: Response to Invitation to Comment

To whom it may concern:

Please accept this response to the Invitation to Comment regarding the expensing of stock options.

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Thank you for your consideration.

Michael Roe
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January 31, 2003

Ms. Suzanne Q. Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Ms. Bielstein:

SUBJECT: FASB Invitation to Comment, *Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, Accounting for Stock-Based Compensation, and Its Related Interpretations, and IASB Proposed IRFS, Share-based Payment (File Reference 1102-001)*

We support the Board's efforts in gaining more information prior to making a decision on the stock-based compensation issue, which recently has impacted the credibility and reliability of corporate reporting. Any perception by the investing public that corporate financial statements do not consistently measure the results of operations of an entity will impact the credibility of corporate reporting, the accounting profession, and ultimately the capital markets.

It is important to note the way credibility and reliability of financial statements is achieved is to make them simple and transparent to users of these statements. Any arbitrary or highly subjective items that comprise major components of revenue or expense can obfuscate the true results of operations and compromise the integrity of corporate financial reporting.

As a result, we do not agree that the way to improve credibility in corporate reporting is to expense employee stock options. There currently is not an accurate, readily available method for determining the fair value of an employee stock option. The definition of "fair value" as defined by Statement No. 123 states that fair value is "The amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale." As employee stock options are not freely transferable, no market currently exists for those equity instruments. The Statement goes on to state that if a market doesn't exist for quoting the fair value of a stock option, valuation techniques including option pricing models may be utilized. The majority of publicly traded companies utilize the Black-Scholes option pricing model to determine fair value. We feel this model, although readily available, does not properly measure the value of employee stock options for the following reasons:

- The fair value of stock options is derived based on several variables relating to the equity instrument's characteristics, the stock's volatility in the market and the interest rate environment. These variables are highly subjective and can create wide differences in valuation with relatively minor changes to certain inputs. This creates the potential for management manipulation of the results of operations.

- Historical volatility of any particular entities common stock, especially for start-up ventures and high-technology issuances, is not necessarily indicative of how the stock price will perform in the future. A company with historically high volatility will derive a higher value for their employee options, all other things being equal, than a relatively lower volatility company. This valuation does not make sense in that an option value of a company in a volatile market whose stock price is declining will actually be higher than the stock price of a company in a relatively stable market. This can also create an instance where the company may record expense for stock options that have no intrinsic value, or are “underwater”.
- Finally, the current Black-Scholes valuation model does not account for the lack of transferability of an employee stock option. The valuation model assumes the option being priced is freely tradable in the open market.

For the reasons listed above, the methodology for recording expense based on the Black-Scholes option pricing model will cause financial statements to lose transparency with highly subjective or arbitrary charges. The cost to the corporation is currently accounted for simply through an increased outstanding share count, which decreases earnings per share. This is very simple and intuitive for readers of financial statements.

Some large corporations are taking a different approach to the valuation of employee stock options and are offering to let unrelated third parties (e.g. investment banks) bid on the options to determine their fair value. We feel this is more closely aligned to the spirit of the Board’s definition of fair value as it matches a willing buyer and seller. However, the stock of large corporations generally has less volatility and is usually more conducive to option pricing model analysis that tends to draw willing buyers. Again, this presents a bias towards larger, less volatile companies over smaller, entrepreneurial companies who trade in more volatile markets. It is our belief that any negative bias towards start-up entrepreneurial companies will obscure the true results of operations for companies in more volatile markets, as well as dampen investment in the capital markets.

Another unintended result of the requirement to expense the value of employee stock options is decreasing employee stock ownership to a broad cross-section of employees. There will be a natural tendency to decrease the income statement impact of stock option issuances by eliminating broad-based employee stock option plans. In some companies, the equity instruments will be reserved for the most senior members of management. The recent headlines are filled with executive abuse of employee stock options and will not be eliminated by the expensing of these employee stock options.

Further, the argument that the value to the employee equals the cost to the corporation is largely based on the assumption that employee stock options are part of a zero-sum game. One individual benefits by the same amount another individual is decremented. There are several studies that cite employees increased productivity as a result of broad-based employee stock ownership. This increases the value of the corporation as a whole at a greater rate than the value of the employee owner. In other words, it creates a benefit for the employee-shareholder without decrementing the value of the corporation of a whole. This creates a dynamic model for growth rather than a static, closed loop system evident in a zero sum game.

How do we then prevent the relatively few cases of abuse that we have experienced in recent months? The answer lies in higher standards of corporate governance in the public markets, more

education on reading and understanding corporate financial statements where disclosures of stock option activity resides, and a greater level of disclosure of corporate management's activities to corporate shareholders. Additionally, standards for compensation committees of corporate board of directors should be promulgated to increase the oversight role and provide the first line of defense in the abuse of employee stock options. Shareholders can be the second line of defense by requiring shareholder approval for all employee stock option programs. We believe the markets should dictate the companies that are abusing shareholder's wealth. We have already seen this with decreased time requirements for filing stock ownership transaction information for senior management, as well as the proposal for quarterly disclosure of option activity. Both of which provide the investing public with more information with which to make their investing decisions.

All of the recommendations mentioned above can be implemented without altering the current accounting methodology for treatment of stock options. For these reasons, we do not support changes to the current accounting treatment of employee stock options.

Very truly yours,

QLogic Corporation