March 7, 2003

Via Email – Original Mailed

Ms. Kimberley Crook
Project Manager
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Re: Exposure Draft 2 – Invitation to Comment

Dear Ms. Crook:

The Semiconductor Industry Association (SIA) appreciates the opportunity to submit comments for consideration to the IASB as it considers Exposure Draft 2 (ED 2 -- accounting for stock options and other share-based transactions). The SIA represents over 90 percent of the U.S. semiconductor industry – our members represent the largest semiconductor makers in the United States[1]. Many of our members have significant operations both inside and outside the United States. Although ED 2 does not request comments on whether employee stock options should be expensed – the members of the SIA strongly believe that employee stock options do not represent an expense – rather, they represent dilution. We are not alone in this belief – there is significant, unresolved disagreement on this issue. In addition, there are no reliable valuation methodologies available for stock options, and so any inclusion of this information – as called for in ED 2 -- would actually make financial statements less transparent, accurate and comparable to the majority of investors. SIA members believe providing the investing public with transparent, accurate and comparable information is of paramount importance and any changes to the rules should bolster this goal – we do not believe that expensing options would lead to more accurate or transparent financial statements because of the inability of current models to reliably and correctly value employee stock options.

[1] The Semiconductor Industry Association (SIA) is the leading voice for the semiconductor industry and has represented U.S.-based manufacturers since 1977. SIA member companies comprise more than 90% of U.S.-based semiconductor production. Collectively, the chip industry employs a domestic workforce of 284,000 people.

Finally, we believe adoption of the proposed standard would limit our ability to grant options to our rank and file workers who currently receive options.

Stock Options Do Not Meet the Definition of an Expense

SIA believes – as do many accountants and academics around the world – that employee stock options do not represent a corporate expense. In fact, we do not believe that they meet the International Accounting Standard's (IAS) own definition of an expense.

Current IAS standards define an expense as an outflow or consumption of assets or creation of liabilities representing actual or expected cash outflows that have occurred or will occur. Employee stock option grants differ from third party grants in that third party grants increase liability and equity equally. SIA agrees that in the context of third party payments, the expense to be recognized should be the fair value of the goods and services received, *i.e.*, the cost to the company and not the value of the equity instruments in the hands of the recipient. These transactions create a specific liability and include some independent means of valuing the goods or services provided to the company granting the options or issuing the stock.

The granting of employee stock options does not result in the creation of a quantifiable liability and leaves the employee with no claim on the assets of the firm – instead, they represent a means of allowing employees to reap the rewards of ownership. Ownership stakes are inherently risky, and do not always yield positive cash flows. As a result, the granting of employee stock options does not meet the accounting definition of an expense. Instead, options represent dilution of ownership. We do not believe that ED 2 includes sufficient detail or explanation as to how and why issuance of employee options meets the definition of an expense. If and when an employee actually exercises an employee stock option, accounting entries are made to record the cash received and the changes to outstanding equity. We do not believe a compelling evidence has been presented to suggest why it is necessary to instead create an expense at the point of issuance of an employee option instead of when a share of stock is actually issued.

It is unclear to the members of SIA why the IASB has not chosen to address the issue of whether or not stock options represent an expense – this fundamental question must be answered before a standard requiring expensing can reasonably be established. A number of those who submitted comments on the G4+1 Discussion Paper raised questions regarding the process the IASB was utilizing to arrive at its decision regarding expensing, most notably, the European Commission. [2] Such questions regarding process are justified, as it is clearly necessary to resolve underlying questions regarding the accuracy of including stock options as an expense before issuing a standard in order to insure the investing public has the best, most accurate, comparable data possible.

Reliable Valuation Methodology for Options Does Not Exist

Existing IAS rightly calls notes that recognition of an expense item is appropriate only when the value of the exchange can be measured with sufficient reliability and in a manner that promotes comparability between companies. Accountants in academia, the private sector and the public sector have yet to agree on the question of how to value stock options. Existing option pricing models, such as Black Scholes and binomial models, were not designed to predict the value of employee stock options and are unable to generate consistently accurate valuations. Black Scholes does an excellent job of predicting the prices at which short-term, minimally restricted options will trade in the open market. The Black Scholes and binomial models, however, do not provide reliable estimates for options of one or more years in duration. The adjustments to Black-Scholes and binomial models proposed by the IASB are insufficient to address this issue fully because they do not take into account all the restrictions that apply to options that affect their value. Employee stock options have durations of five to 10 years, do not vest immediately, are contingent on continued employment, cannot be sold and are subject to various other restrictions including forfeiture and black out dates – all of which makes them difficult to value using the Black-Scholes model. In addition, these models require inclusion of an estimate of future stock volatility – this piece of the model has generally has the largest impact on the valuation model, and is wrong far more often than it is right. SIA and its members believe that it would be highly inappropriate to introduce an expense into company financial statements that is based on such an inaccurate valuation.

The broad and deep dispersion of options within SIA member companies makes potential inaccuracies in valuation more troubling. Companies that issue only a small number of employee stock options – typically to top executives – will be less sensitive to inaccurate valuations being included in their financial statements because those numbers may be so small as to be immaterial.

[2] The European Commission in its February 12, 2001, letter specifically noted that, "it is unrealistic to expect reasoned and informed debate of such controversial issues if the initial discussion document commences by simply dismissing options to which the authors do not subscribe."

This situation appears to characterize many of the companies that recently chose to expense their employee stock options. SIA members, though, grant options to a large segment of their workforce and so fear the inclusion of a large, inaccurate expense. With the same number of options outstanding, companies could experience wild fluctuations in their reported earnings – these fluctuations would have no relation to the financial well-being or performance of the company.

Employee Equity Participation Will Be Negatively Affected

In our industry, stock options are routinely given not only to executives, but also to those well below the executive level – 80-95 percent of options are granted by our members to those below the senior executive level. In addition, most SIA members offer their employees the ability to buy shares through tax qualified Employee Stock Purchase plans (ESPPs). We believe that the IASB proposed standard as currently drafted would adversely affect our members' ability to continue offering such plans. Employee stock options and ESPPs allow us to insure that our employees are able to fully share in the success they have helped make possible. In addition, they are a key means by which we attract and retain our best employees. Our members are engaged in constant global competition for the best and brightest engineers from around the world and we must offer those employees the potential to enjoy the success they help generate through an equity stake – requiring expensing would severely limit our ability to compete for talent through such equity participation.

In summary, SIA members believe that current accounting rules rightly require detailed disclosure on option grants, including their potential dilutive effects. Market share prices directly reflect diluted earnings per share, therefore the cost of stock options is already reflected in the market price of stock. Impact on earnings per share and dilution caused by option grants, therefore, is information that should be made available in a consistent manner to shareholders. If an additional expense was added – in addition to calculating dilution – the effect of options grants would essentially be counted twice.

SIA members are aware of the benefits that could result from the adoption of globally accepted accounting standards – but these benefits will only accrue if the standard is accurate. ED 2 does not represent convergence on a tested and workable standard, and we firmly believe it will not help ensure accurate, timely and transparent financial statements, which should be the ultimate goal of any accounting standard.

Sincerely,

George Scalise
President