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Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

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Mr. Chairman, members of the subcommittee, thank you for inviting me to appear before you today to discuss the very important issue of employee stock options. My name is George Scalise and I am the president of the Semiconductor Industry Association. SIA supports HR 3574, the Stock Option Accounting Reform Act, and we commend your leadership, Chairman Baker, and the leadership of more than 30 members of the Financial Services Committee who are now co-sponsors of the legislation.

Since 1977 SIA has been the leading voice for the U.S. semiconductor industry. Today, SIA member companies comprise more than 85 percent of the U.S. semiconductor industry. Collectively, the chip industry employs a domestic workforce of 255,000 people across the country. The U.S. semiconductor industry is **the** most competitive in the world, and the mission of the SIA – and all of the policy objectives we support -- is to retain that lead.

I will comment on the problems I see with the accounting for employee stock options (ESO), but I also want to leave you with a very clear picture of the implications this issue has for U.S. competitiveness. In addition, I want to leave no doubt that we are talking about **employee** stock options – SIA members give 80-95+ percent of options to employees who are outside the executive offices. Expensing the top five will help address concerns you may have about executive compensation – I trust no one on the panel has concerns about providing an equity stake to non-executive employees. Because options are granted to such a wide cross section of our employees, any requirement to expense all employee stock options, as FASB as proposed, will be material to our members' earnings – thus it is vital that the accounting be right. I believe the current FASB proposal raises more questions than it answers about our ability to value options accurately.

The U.S. High Tech Ecosystem

Just as major industry sectors such as automobiles and steel drove U.S. economic growth in the 20th century, information technology industries, especially semiconductors, are a critical growth engine for the U.S. economy today. The inter-connected web of entities that comprise information technology have helped deliver higher productivity, lower inflation, jobs, better health care, unprecedented prosperity and standards of living, military superiority and increased national security. Semiconductors are, in effect, the brains and nerve center for almost all electronic products today and are thus at the heart of the entire IT sector, enabling everything from advanced computers to medical equipment to weapons systems and contributing **$75 billion annually** to U.S. GDP, more than another other single manufacturing technology.

While semiconductors are at the base of the competitive U.S. information technology sector, the IT sector as a whole is in fact part of a complex and dynamic innovation ecosystem. The interplay between our world class research universities, leading edge industrial R&D, advanced manufacturing, and venture capital is what keeps the U.S. competitive. Superior science and engineering talent is the key to holding this ecosystem together. Our members are engaged in

constant global competition for the best and brightest engineers from around the world and contrary to common belief U.S. companies do not always win that fight.

Semiconductor companies, particularly in Taiwan and China, use stock options as a key recruitment tool – given that those regions do not tax employee options, it is already difficult for U.S. companies to win head-to-head competitions for specific employees. In fact, all you have to do to really understand this dynamic is to go to the Pudong area of Shanghai where you will find numerous expatriate engineers who were hired away from some large U.S. semiconductor companies – lured in large part by huge option grants. The same can be said for Taiwan where 5000 US trained engineers have moved there to work in the information technology industry.

In our industry, stock options are routinely given not only to executives, but also to those well below the executive level – in fact, 80-95 percent of options are granted by our members to those below the senior executive level. We must offer our employees the potential to share in the success they help generate through an equity stake – requiring expensing would severely limit our ability to compete for and retain talent. Jeff Thomas who is here with me today from Altera Corporation is a perfect example – I think you will find what he has to say very compelling. Because options are granted to a very broad cross section of our employee base, any requirement to expense broad based plans would have a material impact on earnings.

Getting the Accounting Right

SIA and its members believe providing the investing public with transparent, accurate and comparable information is of paramount importance and any changes to the rules must bolster this goal. Getting the accounting right is a formidable challenge.

Accountants in academia, the private sector and the public sector do not all agree that employee stock options are a corporate expense to be deducted from earnings. Some would have you believe that that fundamental threshold question is not debatable. Quite to the contrary – there is anything but a consensus view that employee stock options are a corporate expense.

Similarly, there is absolutely no consensus among experts on how to value employee stock options accurately, reliably and consistently if they were to be expensed. No one has yet found an appropriate method to value employee stock options. That is why, despite years of study by not just FASB but also by some of the smartest mathematicians and economists in the world, FASB still can't suggest a single, precise option pricing model. Let me reiterate that point. Despite working on this for more than a decade, despite convening an "Option Valuation Group," hand-picked by FASB to come up with a new model, despite all kinds of research by others – FASB is still left with a hypothetical model designed for something entirely different – freely tradable options. The just released exposure draft proposes the same two models – binomial and Black-Scholes – that it identified 10 years ago when it adopted the current standard. The valuation ball has moved not one inch. And I believe that you can't expense what you can't accurately value.

Why are employee stock options not a corporate expense? [1]. Briefly put, an employee stock option is an incentive compensation instrument designed to attract and retain the best available employees, and to provide an equity stake in order to increase the employee's productivity to a level in excess of that which could be achieved by cash or fringe compensation alone. Accordingly, the express

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[1] This section relies in large part on *Stock Option Expensing: Getting the Accounting Right*, Kip Hagopian, March 29, 2004, as found at www.sia-online.org.

purpose of an ESO is not to raise new equity capital but to increase the value of the issuer's existing equity. 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. As a result, the granting of employee stock options does not meet the accounting definition of an expense. Instead, options represent dilution of ownership.

Beyond this core accounting issue, it also must be emphasized that employee stock options truly are unique financial instruments – significantly different than the type of options for which the Black Scholes model was designed -- which is why valuation remains an intractable challenge.

- Whereas tradable options are sold on the open market, ESOs may only be granted to employees. In other words, employees are the only market for ESOs. In its draft, FASB notes that the most accurate determination of fair value requires a willing buyer and a willing seller – however, by definition, such an arrangement cannot exist for ESOs, which are highly restricted.
- ESOs are not actually stock options until they vest, which may occur on periodic fixed dates or on a single fixed date several years out in the future.
- ESOs are not transferable to anyone at any time, even to another employee of the issuer. This means that neither the ESO agreement nor the option itself can be sold either before or after it vests. As a result, the only way that an employee can benefit financially from an ESO is to stay with the employer until the option vests, then exercise it and sell the underlying stock.

The broad and deep dispersion of options to all levels of employees 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. 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.

Tax Treatment

Tax treatment for ESOs is fairly straight forward. When an ESO is exercised, the difference between the exercise price and the fair market value on the date of exercise is a taxable gain to the option holder and a tax-deductible expense to the company that granted it. The IRS prohibits the expensing of an ESO for tax purposes until it is exercised, mainly because the IRS does not believe that ESOs have a "readily ascertainable market value" at grant date. In the absence of such, the IRS has opted to wait until a value has been clearly determined. The FASB draft assumes that expensing would take place on the grant date, although they have solicited comments on this question.

Employee Stock Purchase Plans (ESPPs)

A major fatality of stock option expensing would also be the Employee Stock Purchase Plans (ESPP) which the majority of SIA member companies offer to their employees. ESPP plans allow all eligible employees throughout the world to buy company stock at a discount via payroll deduction several times a year. Usually the amount of the discount is 15% -- yet proposed changes

would require expensing of any options granted with more than a 5% discount. It is very **likely that many companies will not bother with a 5% discount and these plans will cease to be offered**. These plans are open to 100% of our workforce, in companies that have such a program and employees actively participate in these plans. It is a very real way for employees to benefit as the value of a company increases, thus improving productivity. And when productivity improves, shareholder value goes up. In this way, all of the investors in a company benefit from ESPP plans. Yet FASB's exposure draft may kill ESPPs in one fell swoop.

Summary

SIA members believe that current accounting rules rightly require detailed disclosure on option grants, including their potential dilutive effects. In addition, 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. Companies report diluted earnings per share already, which make this impact clear.

Part of the rationale for seeking expensing of ESOs is the quest for international convergence. The International Accounting Standards Board (IASB) – based in Europe – is seeking expensing as well. Adoption of the draft standard they put forward is very much up in the air. It must first go through a vigorous review process within the European Community – the outcome of that review is not at all a sure thing. It is not clear to SIA members why the actions or proposals of the IASB should govern the timetable for accounting changes in the United States.

In our industry, stock options are routinely given not only to executives, but also to those well below the executive level – as already noted, 80-95+ percent of options are granted by our members to those below the senior executive level. Options 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. It is also the best opportunity our employees have to build an equity position for their family. 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. I would urge you to pay very close attention to this fact as you seek to reach a position on this important legislation.

I would be happy to answer any questions you might have regarding our position.