CL 165

7th March 2003

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

Dear Ms. Crook,

Share-Based Payment – ED 2

I am writing to you to express my views on ED2 as a Chartered Accountant and Finance Director with responsibility for the financial reporting in 12 countries throughout Europe, Middle East and Africa.

I attach a copy of the comments made by my colleague, Mr Doyle, on behalf of our employer Xilinx. I concur fully with the view expressed on the inconsistent principles of expensing stock options, the difficulties in measuring the 'cost' of employee stock options and the concerns with the comparability and transparency of financial reporting.

Stock options should not be treated as an employee expense as they merely represent the dilution of ownership to shareholders. Many shareholders are indeed happy to see the granting of employee stock options as they align the interests of management, employees and shareholders as well as encouraging employee loyalty. The shareholders can evaluate the impact of dilution through reviewing the different earnings per share calculations under existing standards.

The difficulties in measuring the expense to be charged under the proposal should not be underestimated as my colleague has noted. From a practical standpoint, the time and effort to look at the various valuation models as well as estimations in the length of time employees are likely to remain at the company will be onerous to finance teams. Indeed the complicated calculations, difficulties with valuation assumptions, problems with tracking employment patterns and the requirements for audit will require substantial additional work. If this extra effort enables clearer understanding of the financial accounts then it would be worthwhile; however, I feel this would only add to more problems for the reader of the accounts in interpreting the financial information.

If ED2 is enacted, then it is likely to have a significant negative impact on the extent of employee share options being granted to all employees in a variety of international companies. This seems to conflict with government initiatives in both the UK and Europe over the last few years to promote share ownership. Indeed ED2 is likely to frustrate these plans with reduced employee shareholders if proposals go ahead. Also in the UK, Proshare have noted concerns on behalf of small shareholders and has highlighted many of the issues.

There is also concern for smaller and start up companies, who frequently use stock options to attract and retain employees and enable them to share in the future success through share ownership and capital value. The expensing of options combined with time consuming work noted above would actively discourage small companies from granting options. This will potentially make it difficult for them to attract employees and grow the business, thereby depriving industry of potential strong companies for the future which the UK and Europe needs.

In conclusion, I feel that employee options should not be treated as expenses. The valuation problems will I believe not lead to any clearer information for the users of the financial statements and there are concerns over the negative impact of ED2 on the number of share options scheme with a resulting adverse impact on savings rates, share ownership and small companies alike.

I do not believe that ED2, especially regarding equity based options, will provide the high quality and understandable financial reporting with transparent and comparable information which the IASB has as its declared goal.

Yours faithfully,

Ian Simpkin, MA (Cantab), FCA,
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7th March 2003

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
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United Kingdom

Dear Sir David,

Share-Based Payment – ED 2

Xilinx Inc is a US corporation headquartered in California, USA. It has a number of subsidiaries throughout Europe, Asia and Japan. Xilinx is a semiconductor company and is the world's leading supplier of complete programmable logic solutions. It develops, manufactures, and markets a broad line of advanced integrated circuits, software design tools and intellectual property. Xilinx is quoted on the NASDAQ. ('XLNX').

Xilinx offers stock option plans to its employees. Nearly all of our employees participate in the plan, with 14% of the options going to the top five listed officers and 86% going to the rest of the employees.

Xilinx welcomes this opportunity to offer its comments on the Exposure Draft ED 2 *'Share-Based Payment'* . Our concerns and responses focus primarily on employee stock options and not on the other share based payments described in ED2 and our concerns relate to the scope, recognition, measurement issues and comparability of financial performance, and potential economic impacts.

Scope of the proposed Standard

We note it is proposed that the draft IFRS should apply to all entities and to all types of share based payments. Whilst we support overall aim to develop a standard to ensure uniform recognition and measurement principles for all share based payments we believe that its scope is drawn too wide. We agree that the standard should be applicable to all entities. However, we believe that there should be scope limitation on the types of transaction covered by the standard. Specifically, we believe the standard should be limited to share based payments for goods and non-employees services and therefore should specifically exclude employee share option plans.

Stock options and expensing

The overall approach taken in the ED has not been reconciled with the IASB's own Framework. In particular, there is some lack of consistency in the definition of loss/expense in the Framework compared with the ED. ED2 in paragraphs BC40-BC48 attempts to demonstrate that employee stock options are within the definition of an expense. The Framework states that:

> 'Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurring of liabilities that results in decreases in equity ….'

However, in our opinion this fact is not proven, the comparisons made are tenuous and fail to explain how employee stock options meet the expense definition.

In our view when employee stock options are granted a liability is not created at date of grant or at any future date and there will not be an outflow of resources or a reduction in the entity's assets. It is arguable that there is a potential opportunity cost resulting from the foregoing of a cash asset for the issue of the options but this is an entirely different matter that should be separately considered.

The ED states that employee stock options issued are in return for the consumption of employee services and that these services are consumed immediately when the employee provides them to the company. We consider this to be a flawed assumption. The award of stock options does not result in the consumption of the entity's assets. The employee may not do something incremental to result in additional cost to the entity at time of receipt of the stock option. Nor is there unrefutable evidence that the entity receives separate services in return for the issue of stock options in all cases. To make this comparison fails to appreciate the underlying intention of and value of stock options.

Stock option plans vary from company to company. In some companies the issue of stock options is limited to upper management. Other companies embrace broadly based stock ownership plans and wider share ownership among employees. Broad-based plans are a particular feature of high tech companies and in some emerging business sectors. There is a propensity of high-tech companies based on the west coast US. Standards of living and payroll/ payroll related costs are amongst the highest in the world clearly demonstrating that stock options do not necessarily substitute for payroll and should not be viewed in that context.

There is a view in certain quarters that employees will accept lower payroll remuneration in return for stock options and this results in lower employee costs in the income statement as substitute for capital investment. This can be a feature in some smaller companies, particularly in early stage development as all available resources are ploughed back into the business. This is not unlike owner managed businesses generally. However it would be a mistake to assume that this is the case for all companies. It is not an appropriate generalisation for large and/or publicly traded companies

From companies that issue stock options only to senior officers of the company it is not necessarily the case that payroll related earnings of those officers are lower than that of officers in other companies where stock option programs are less generous to senior officers. Neither is it the case for those companies that do not have stock option plans. The purpose of stock options is primarily to give employees an equity stake in their company

The underlying philosophy of share options is to attract the best available talent to the company by providing employees (current and prospective) with an opportunity to share in the future success of the entity through share ownership and capital value. Employee stock options align shareholder and employee incentives and goals and help to drive synergies and overall performance allowing employees to share in the growth and prosperity of the company and increasing value to all shareholders. Shareholders acknowledge and accept this process by approving employee stock option programs and accept the dilutive nature of these programs as they expect the overall increase in their capital value to outweigh the dilutive effect of these programs. Performance measurement is assessed through the earning per share calculation.

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Measurement issues and comparability of financial performance

There has been much discussion on the proposed measurement approach and in particular the use of option pricing models to calculate the proposed stock option expense. The draft standard discusses two models, 'Black-Scholes' and the 'Binomial' models. It is noted that these models were designed to value traded options and are not particularly suited to employee stock options due to their inherent differences, the principles differences being

- traded options are short term in nature whereas employee stock options are longer term (up to 10 years)
- employee stock options vest over time, conditions attach to vesting, are forfeited on termination
- employee stock options are not tradable/transferable

and these are discussed in paragraph BC 144 and subsequent paragraphs of the ED.

In addition there are six factors listed to be taken into account in valuing options (exercise price, market price, expected volatility, dividends, interest rate and option term). We believe this is not an exhaustive list and that other factors will also need to be factored into any option-pricing model depending on the particular circumstances. These variables together with the inherent limitations noted in the previous paragraph make for significant levels of estimation and judgement and thus significant measurement issues to be overcome.

The ED suggests that the assumptions made will navigate around these issues, but we are concerned that using such uncertain inputs applied in a detailed model will produce an unreliable output. Since reliability is one of the key premise's in the IASB's Framework, the increased risk associated with the subjectivity in measuring the potential cost may result in unrealistic/hypothetical charges to the income statement rendering the whole process unreliable, misleading and thus unworkable.

These option-pricing models are very sensitive to small changes in subjective inputs. For example, volatility is a significant issue in valuing options and assumptions with respect to volatility can significantly impact option valuation as can other variables. The recording of an expense that is subject to widely ranging values can only serve to impact the accuracy of financial reporting and increase the risk of potential misstatement, reduce the comparability of financial reporting and adversely impact the user's ability to interpret the financial performance of the entity. This defeats the overall objective of comparable and transparent measurement of financial performance across different companies and geographies.

In addition to not supporting the expensing of stock options per se, we wish to also point out that we do not support any proposal to continue charging an expense for options that have been forfeited, or for options where the price is 'underwater', and where there is no prospect of exercise and no associated service value.

Potential economic impacts

The introduction of stock option expensing may have certain undesired economic consequences. We note that the ED indicates that this should not be a reason for not recognising the expense. This would be a reasonable argument if the absence of regulation was leading to abuse but it is inappropriate in this instance.

We believe there are a number of potential impacts which would be bad for businesses overall

- potential issues for companies if stock option expensing becomes a mandated cost where there is an inability to negotiate increased prices This may cause significant difficulties for some companies in pricing services, contracts and products going forward as customers may not accept the changed cost basis resulting in a reduction in the overall profitability and performance of the entity, potentially impacting loan covenants, debt ratings and ultimately the going concern of an entity as a consequence of change in an accounting measurement basis

- the potential impact the ED may have on cost sharing agreements. Expensing of share options will drive up implementation costs of such agreements and may adversely impact economics of certain partnerships/joint ventures

- the possibility that the proposed standard will lead to the cessation of broad based employee share ownership schemes. Stock option programs are a very desirable wealth generator for economies and their discontinuance would be undesirable for economic growth

- potential risk of a permanent outflow of funds from stock markets into other investment categories reducing overall stock market valuation and wealth.

Requiring companies to change accounting methodology will create other far reaching impacts and these need to be balanced against the perceived benefit of the accounting change. Under currently proposed methodology, companies having stock price volatility or where their stock prices are increasing will incur a higher stock option expense than a lower performing company. Non-cash compensation costs could increase faster than revenue growth only because the company is performing well and generating higher cash flows. An accounting methodology that causes a company to report lower margins or results when cash flows are increasing is wrong. Consequently, some companies may feel it necessary to abandon stock option programs and/or restructure stock option programs. Implementing accounting rules that produce results counter to the economic activity of an entity is not appropriate.

Governance issues and Disclosures

Following the breakdown in corporate governance, ethics and good judgement, that resulted in a number of high-profile company collapses the purpose and accounting for stock option programs has become an issue of debate. Current opinion seems to suggest that stock options are primarily a substitute for payroll related costs and there is a causation between stock options and breakdown in corporate governance and ethics. As such, stock options are deemed to be a form of expense to be recognised in the income statement. However, as clearly outlined earlier, we do not concur with this view and believe that the answers to the issues that gave rise to the stock option abuses are improved disclosures, increased accountability by management and the board, and a better system of oversight and reporting.

Xilinx is in favour of increasing disclosure on stock option plans, but against expensing options through an entity's income statement. Accordingly we support the increased disclosures proposed in the ED to enable the reader of financial statements to more fully understand the nature, extent, distribution profile and value of stock option programs to employees and senior management in entities.

Conclusions

In summary we concur with the proposals in the draft standard requiring the expensing of certain share based payments but we strongly advocate that the standard should be limited to share based payments for goods and non-employees services and to specifically exclude employee share option plans.

We believe that the principle of expensing employee stock options is not appropriate or consistent with the underlying philosophy for issuing stock options. Furthermore the significant issues and judgements required in measuring the 'cost' of employee stock options could render meaningless the financial results and profitability of entities and reduce the comparability and transparency of financial reporting overall.

We fully support detailed and timely disclosures of stock option information in the notes to the financial statements and improved corporate governance processes to enable avoidance of abuses.

Yours truly,

David Doyle
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Xilinx Inc
Logic Dive, Citywest Business Campus
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Ireland