Letter of Comment No: 5778 File Reference: 1102-100

June 30, 2004

Ms. Suzanne Bielstein Director of Major Projects – File Reference Number 1102-100 Financial Accounting Standards Board 401 Merritt 7 P. O. Box 5116 Norwalk, CT 06856-5116

Dear Ms. Bielstein:

On behalf of National Semiconductor, I appreciate the opportunity to provide comments on the Board's recent proposal regarding the accounting for employee stock options. We support the Board's efforts to increase clarity and consistency of financial statements but we believe that the Board's proposal will undermine these goals. Specifically, we have significant concerns that financial statements and investor information will be impaired by consideration of employee stock options as an expense and by the application of the Black-Scholes or binomial/lattice valuation methods.

National Semiconductor, the industry's premier analog company, creates high performance analog devices and subsystems. National's leading-edge products include: power management circuits, display drivers, audio and operational amplifiers, and data conversion solutions. National's key markets include: wireless handsets, displays, PCs, networks, and a broad range of portable applications.

National currently employs approximately 9,800 people worldwide. We believe that our continued success depends fundamentally on our ability to recruit and retain skilled technical and professional personnel, in large part through the use of employee stock option and employee stock purchase plans. Given the importance of employee stock options and purchase plans as a means of attracting and retaining skilled talent within our company, we have strong concerns regarding the Board's proposal.

As an initial matter, we do not believe that employee stock options are a corporate expense from an accounting standpoint. Much of the stock options debate centers around the value or perceived value of a stock option to an employee versus the cost, if any, of such options to the issuing corporation.

Although an employee stock option represents something of potential or future value to an employee, the issuance of employee stock options does not represent an expense to the corporation but rather a potential for future dilution of outstanding shares. Existing

accounting rules regarding disclosure of shareholder dilution reflected in the earnings per share data provide an accurate and appropriate reflection of this potential dilution.

A more significant concern, is the impact on financial statements if employee stock options are recorded as an expense using the Black-Scholes or binomial option valuation models recommended by the Board. In short, we believe that these methods are seriously flawed when applied to employee stock options and the resulting income statements that include these expenses will be less accurate and less comparable than they are under the current standards.

Current option pricing models, including the Black-Scholes and binomial models recommended by the Board, produce wide-ranging and therefore often misleading results when applied to employee stock options because many of the unique features of stock options are not taken into account by these models. The Board's proposal does not provide guidance on how option pricing models can be adjusted to provide discounts that account for the many attributes of employee stock options that should impact their fair value.

The Board's proposal would also require a significant number of predictions, related to future employee exercise behavior, dividends, interest rates and other factors that are impossible to predict with accuracy. The most significant of these predictions relates to corporate estimates of future volatility. Yet, for companies in the technology industries, future events including development of new products and technological developments are impossible to predict. Further, the impact of these events on stock volatility is similarly unpredictable.

Under the Black-Scholes and binomial models, option value is largely determined by predicting future stock prices based on volatility. Yet, these long-term forecasts are extremely unreliable, particularly for technology companies. As a result, the Board's proposal, which does not recommend a standard, appropriate input for volatility, will provide results that are unreliable and not comparable across companies or industries.

We recognize that the Board does not consider the economic impact of its proposals. However, we believe that it is critical to recognize that a mandatory expensing standard is likely to impact the ability of companies to offer employee stock option plans, as such plans would be more "expensive" in accounting terms.

For companies such as ourselves, that broadly issue employee stock options, the inaccuracies that result through application of existing option pricing models will have a material negative impact on financial statements. Companies that issue options to only top officers will not be as significantly affected. This is clearly counterproductive, given the public interest in improving corporate governance and addressing executive compensation issues.

Competition for technical talent in the semiconductor industry is intense. We compete with a number of major corporations in the high-volume segment of the industry. These

include several multinational companies whose semiconductor business may be only part of their overall operations. We are extremely concerned that the Board's proposal will negatively impact the ability of U.S. companies to attract and retain the leading innovators and technology talent that we require to stay ahead of our global competitors. This is a particular concern when our global competitors (particularly those in Asia) are increasingly embracing employee stock options as a tool to attract and motivate their workforce, and they will not be faced with an expensing mandate. The U.S. technology industry will clearly be at a disadvantage vis-à-vis our foreign competitors.

Finally, we wish to express similar concerns regarding the Board's proposal to treat Employee Stock Purchase Plans as compensatory. Many major employers have long offered ESPP's to their employees. More recently, these programs have proven to be particularly popular in the high technology industries where broad employee ownership has proven instrumental in the success of the businesses. In fact, a recent informal poll of publicly traded semiconductor companies revealed that the overwhelming majority offered ESPP's to their employees. We are concerned that broad Employee Stock Purchase Plans will be threatened by the Board's proposal.

We believe the Board should retain the current standard under Statement No. 123. The flexible approach set forth in Statement No.123 is appropriate and a mandatory expensing standard should be rejected. At the time Statement No. 123 was adopted, the Board considered current option pricing models an adequate way to value employee stock options. The data that has been developed since Statement 123 was adopted shows that while the Board and others may believe current pricing models are adequate, they are not.

At a minimum, we would urge the Board to implement a comprehensive, detailed program of field-testing by companies in a range of industries, before any new standard is adopted. We believe such field-testing would illuminate many of the flaws of the Board's proposed approach, and may provide guidance as to whether and how a meaningful method of valuing employee stock options might be developed.

In the meantime, the current accounting standard, combined with meaningful disclosures about employee stock options, will provide investors with the most accurate and comparable information available about employee stock options.

We thank you for the opportunity to provide these comments.

Sincerely,

Lewis Chew Chief Financial Officer National Semiconductor Corporation

Recognition of Compensation Cost

Issue 1: The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations (refer to paragraphs C13–C15). Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.

We agree with the Board's conclusion.

Issue 2: Statement 123 permitted enterprises the option of continuing to use Opinion 25's intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26-C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why not?

The decision under SFAS123 to allow enterprises to continue to use the intrinsic approach (with supplemental disclosures) was a compromise position with which, we understand, the Board felt uncomfortable. We agree with the Board that pro-forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements.

Measurement Attribute and Measurement Date

Issue 3: This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Paragraphs C16–C19 and C53 explain why the Board believes fair value is the relevant measurement attribute and grant date is the relevant measurement date. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?

We agree with this view.

Fair Value Measurement

Issue 4(a): This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current

price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share, and the risk-free interest rate (paragraph 19 of Appendix A). Due to the absence of observable market prices, the fair value of most, if not all, share options issued to employees would be measured using an option-pricing model. Some constituents have expressed concern about the consistency and comparability of fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model (paragraphs B13–B30). Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?

We believe the proposed Statement provides sufficient guidance.

Issue 4(b): Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note that the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. For the reasons described in paragraphs C21–C25, the Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model (as defined in paragraph E1) is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, for the reasons noted in paragraph C24, the Board decided not to require the use of a lattice model at this time. Do you agree with the Board's conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that a lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options. If not, why not?

We agree that the fair value of an option can be measured with sufficient reliability to allow it to be reflected in the financial statements. The key issue here is the concept of "sufficient reliability" — many numbers in financial statements are estimates although the ultimate realisation in cash of the underlying transactions will "true up" these estimates. Such truing up will result, ultimately, in a correct amount reflected through the financial statements. However, on the presumption that employee share options are compensation, a <u>correct</u> amount cannot be aspired to or achieved (even with the intrinsic approach) — the requirement should be restricted to sufficient reliability and we believe share options can be measured to this extent.

A lattice model is preferable – many features of employee share options cannot be reflected in the Black-Scholes model – but we note that the availability of such models is, at present, limited. Accordingly, we believe that recommending, rather than requiring, the use of a lattice model is the correct approach.

Issue 4(c): Some respondents to the Invitation to Comment suggested that the FASB prescribe a single method of estimating expected volatility or even a uniform volatility assumption that would be used for all companies. Other respondents to the Invitation to Comment disagreed with such an approach. Additionally, some parties believe that historical volatility, which has been commonly used as the estimate of expected volatility under Statement 123 as originally issued, is often not an appropriate measure to use. The proposed Statement would require enterprises to make their best estimate of expected volatility (as well as other assumptions) by applying the guidance provided in paragraphs B24–B26 to their specific facts and circumstances. In that regard, the proposed Statement provides guidance on information other than historical volatility that should be used in estimating expected volatility, and explicitly notes that defaulting to historical volatility as the estimate of expected volatility without taking into consideration other available information is not appropriate. If you believe the Board should require a specific method of estimating expected volatility, please explain the method you prefer.

No. We believe that entities should estimate expected volatility based on their own circumstances and methodology.

Issue 4(d): This proposed Statement provides guidance on how the unique characteristics of employee share options would be considered in estimating their grant date fair value. For example, to take into account the non-transferability of employee share options, this proposed Statement would require that fair value be estimated using the expected term (which is determined by adjusting the option's contractual term for expected early exercise and post-vesting employment termination behaviors) rather than its contractual term. Moreover, the Board decided that compensation cost should be recognized only for those equity instruments that vest to take into account the risk of forfeiture due to vesting conditions. Do you agree that those methods give appropriate recognition to the unique characteristics of employee share options? If not, what alternative method would more accurately reflect the impact of those factors in estimating the option's fair value? Please provide the basis for your position.

We agree with the proposed guidance.

Issue 5: In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date (paragraphs 21 and 22 of Appendix A). Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value? (Refer to paragraphs C66 and C67 for the Board's reasons for selecting that method.) If not, what other alternative do you prefer, and why?

We agree that, should it not be possible to estimate the fair value of an equity instrument, the intrinsic value should be used. However, we believe that such circumstances would be rare and would like any final Statement to emphasise this.

Employee Stock Purchase Plans

Issue 6: For the reasons described in paragraph C75, this proposed Statement establishes the principle that an employee stock purchase plan transaction is not compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares. Do you agree with that principle? If not, why not?

We agree with the principle. The existing 5% discount test is not conceptually sound – in many employee stock purchase plans the key attribute is the ability to purchase at a predetermined price at a future date as opposed to the discount itself.

Attribution of Compensation Cost

Issue 7: This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?

We agree that the requisite service period is the appropriate period over which to recognize the compensation cost.

Issue 8: Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Paragraphs B37–B49 provide guidance on estimating the requisite service period. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?

The guidance goes some considerable way in illustrating the provisions of the proposed Statement. However, many examples would benefit from complete solutions, as opposed to indicative guidance.

Issue 9: For the reasons described in paragraphs C89–C91, the Board concluded that this proposed Statement would require a single method of accruing compensation cost for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why not?

We agree with the accounting treatment proposed.

Modifications and Settlements

Issue 10: This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity instruments (paragraph 35 of Appendix A). Paragraphs C96–C115 explain the factors considered by the Board in developing those principles and the related implementation guidance provided in Appendix B. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance provided in Appendix B.

We believe these principles are appropriate, complete and sufficient.

Income Taxes

Issue 11: This proposed Statement changes the method of accounting for income tax effects established in Statement 123 as originally issued. Paragraphs 41–44 of Appendix A describe the proposed method of accounting for income tax effects and paragraphs C128–C138 describe the Board's rationale. That method also differs from the one required in International Financial Reporting Standard (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?

We believe that the approach set out under IFRS 2, whereby the deferred tax is remeasured at each intervening period, is more technically correct. However, the FASB approach has the benefit of simplicity (and, where there are multiple schemes, practicality). For this reason, we are willing to accept the approach proposed in the Statement. However, we would question whether there are likely to be any material differences in practice between the two approaches and, therefore, whether the non-convergence with IFRS 2 is justified.

Disclosures

Issue 12: Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives (paragraph 46 of Appendix A). Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives (paragraphs B191–B193). Do you believe that the disclosure objectives set forth in this proposed Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.

We believe the disclosures are appropriate.

Transition

Issue 13: This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application (paragraphs 20 and 21). The Board's rationale for that decision is discussed in paragraphs C157–C162. Do you agree with the transition provisions of this proposed Statement? If not, why not? Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?

The transition arrangements proposed in the Statement represent an element on non-convergence with IFRS 2, particularly in respect of retrospective application. We would recommend permitting full retrospective application for those entities that have disclosed (as opposed to accounted for) share-based payment information under SFAS No.123.

Nonpublic Entities

Issue 14(a): This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow an intrinsic value method for nonpublic entities? If not, why not?

No. We believe that the intrinsic method should only be used in exceptional circumstances, as set out in Issue 5 above. We do not believe that the intrinsic method should be available to a specific class of entities. In any event, we are not convinced that the concession will result in less onerous requirements for nonpublic entities. It would require such entities to estimate the fair value of the underlying instrument at each intervening balance sheet date, which we believe would be as onerous, if not more so, than estimating the fair value on grant.

Issue 14(b): Consistent with its mission, when the Board developed this proposed Statement it evaluated whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or the intrinsic value method (with final measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provide them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?

We believe the extension of the effective date for nonpublic entities is appropriate. However, as set out in Issue 14(a) above, we do not agree with the concession to allow the use of the intrinsic method by nonpublic entities.

Small Business Issuers

Issue 15: Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for nonpublic entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?

No, for the same reasons that we do not agree with the concession for nonpublic entities as discussed above.

Cash Flows

Issue 16: For the reasons discussed in paragraphs C139–C143, the Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid (paragraphs 17–19). Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?

No, we do not agree that the reasons set out in paragraphs C139-C143 justify the amendment of Statement No.95 nor do we believe the proposed approach avoids potential non-convergence with IFRS2 – we can find no reference in either IFRS 2 or IAS 7 "Cash Flow Statements" to suggest that international accounting requires such a treatment. We believe the proposed approach would result in disclosure of cash inflows not supported by actual cash flows to the entity.

Differences between This Proposed Statement and IFRS 2

Issue 17: Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe the Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?

We fully support convergence between the guidance issued by the IASB and the FASB. We believe the proposed Statement should converge and, as noted above, we believe the areas of non-convergence are such that amending them would not result in more onerous, unreasonable or impractical requirements.

Understandability of This Proposed Statement

Issue 18: The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?

Yes.