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Proposed Statement of Financial Accounting Standards, "Share-Based Payments, an amendment to FASB Statements No. 123 and 95"

INTRODUCTION

On behalf of ASML Holding N.V. (ASML), we submit these comments to the Financial Accounting Standards Board (FASB) in response to the Exposure Draft on the proposed amendments, referenced above ("the ED").

ASML is world's leading provider of lithography systems for the semiconductor industry, manufacturing complex machines critical to the production of integrated circuits or chips.

ASML's corporate headquarters is in Veldhoven, the Netherlands. The company has lithography research, development and manufacturing operations in Wilton, Connecticut, U.S. and Veldhoven, the Netherlands. Technology development centers and training and application facilities are located in Asia, Europe and the United States. ASML is traded on Euronext Amsterdam and NASDAQ under the symbol ASML.

ASML follows accounting principles generally accepted in the United States of America ("U.S. GAAP") and files its Annual Report on Form 20-F at the Securities and Exchange Commission under commission file number 025566.

Each year, ASML issues stock options to purchase ordinary shares for eligible employees and its Board of Management. Consistent with the majority of companies operating in the semiconductor equipment industry, ASML accounts for its stock options plans using the intrinsic value method under APB 25, and provides pro forma disclosure of the impact of the fair value method on net income and earnings per share. Accounting for stock option plans under the standards proposed in the ED will have material impact on our financial statements.

ASML COMMITMENT TO TRANSPARENT ACCOUNTING

For ASML, the clarity, relevance and comparability of our financial statements is a paramount concern. Our Chief Executive Officer and Chief Financial Officer are required to certify that financial statements "fairly present in all material respects the financial condition ... of the issuer"¹.



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These certification requirements are "not limited to a representation that the financial statements and other financial information have been presented in accordance with 'generally accepted accounting principles'" *Id.* Rather, executives must certify to "a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles." *Id.* The SEC considers the certification to include "selection of the appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and *reasonably reflects the underlying transaction and events*" *Id. (emphasis supplied).*

The requirements to reasonably reflect the underlying transaction whereby employees are granted stock options makes it essential that FASB's new standards for employee stock options gets the accounting right. Therefore, ASML has seriously considered the potential effect of the ED and its proposed amendments to Statements 123 and 95 on the quality of financial reporting for its shareholders and the investor community at large.

ASML supports full disclosure to investors on the dilutive impact of its stock option plans. We also believe that currently mandated footnote disclosure in financial statements and additional disclosure in SEC filings, fully describe the effect that a compensation charge would have on bottom-line financial results as well as their impact on shareholders and executive compensation.

SUMMARY OF COMMENTS

Our comments in this letter will address these significant financial reporting issues. They are summarized here.

1. Regarding the proposed requirement for a fair value charge at grant date:
 - There is no adequate means of valuing an employee stock option at grant date;
 - Employee stock options are unique financial instruments, which are not comparable to market-traded option contracts;
 - Use of the lattice or Black-Scholes models to value stock options will introduce assumptions and predictions into the financial statements that will impair comparability and usefulness for investors; and
 - The absence of guidance on a number of key implementation matters would further diminish the accuracy, comparability and consistency of financial statements.
2. In addition, we believe that investors get more-than-adequate information from current accounting and that current accounting serves investors in a manner superior to that which investors would receive under the ED. We are aware of no circumstances where investors have been misled by current financial reporting on the impact of our stock options on the finances of ASML. We do not believe that these proposed amendments would improve financial reporting or assist investors in understanding the impact of our stock option plans.
3. Regarding the objective of this ED to achieving greater international comparability in the accounting for stock options. If the FASB pursues the amendments proposed in this ED, there will still remain differences with IFRS on transitional provisions, recognition and measurement of compensation expense. As ASML is stock quoted on Nasdaq and Euronext, ASML will have to report its financial results from January 1, 2005 onwards both in accordance with U.S. GAAP and IFRS. This ED will create confusing to our investors and not enhance the transparency of our financial reporting.
In order to be transparent to our investors, we would recommend to provide us the option to account for stock option grants using the intrinsic value method under U.S. GAAP.



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4. Finally, ASML concurs with the views of the international semiconductor industry association SEMI, stated in previous comments by the SEMI to the FASB on the question of whether stock options should be a compensation expense, that the economic impact on the international economy of this proposal will be negative and severe.

I. SPECIFIC COMMENTS ON KEY ISSUES

Issues 1 & 2: Recognition of Compensation Cost

Investors get better information from current accounting standards than they would under the proposed amendments.

Amendment of Statement 123 to require recognition of a compensation cost will not improve financial reporting. Various arguments are made in the ED, and have made elsewhere, in support of recognition of a compensation cost in the income statement. However, we are aware of no instance—or even a claim—that investors were misled to their detriment by the current accounting treatment and extensive footnote disclosures of employee stock options. Shareholders, the investing public and equity analysts have sufficient information to determine the full impact of employee stock options in each reporting period. Under the basic requirements of GAAP reporting today, our investors receive all the information that the ED would require on the impact of stock options on our net income, earnings per share and more. The typical footnote disclosure in a company's annual report includes these types of information as required by Statement 123:

- pro forma footnote disclosure of net income and earnings per share based on the inclusion of an expense for stock options granted annually for the current year and the previous two years;
- a summary table of stock options plans with weighted average exercise prices for options granted and the number of options granted and available for grant under the plans; and
- a description of assumptions used in developing the fair value of options granted.

In addition, the SEC requires extensive disclosures regarding option plans, their dilutive effect and option grants to officers and directors. Indeed, some believe that company reports contain so much information about stock options that it distracts investors from more important aspects of financial reporting and SEC disclosure. However, we maintain that these enhancements to disclosure, particularly the additional voluntary disclosures are an appropriate response to some investors's concerns. Current disclosures help investors understand what stock options are: *potentially* dilutive instruments that motivate employee effort beyond the ordinary. Current accounting also informs investors that stock options are not an appropriate, measurable compensation cost to the company. The proposed amendments send the opposite, incorrect message.

Issues 3 & 4: Measurement Date and Fair Value Measurement

- A. There is no adequate means of valuing an employee stock option at grant date.

ASML believes that there is no appropriate date for measuring any compensation cost of stock options. However, we agree that, from a list of bad choices, grant date is the most feasible date for measuring fair value. Grant date is only the best of various bad choices because there is no adequate means of valuing an employee stock options at grant date. Therefore, the ED's proposed treatment of stock options will neither enhance the transparency, nor improve the quality of financial reports for our investors.

The ED proposes to require that an expense be measured for stock options at the grant date and that the amount of the expense be based on the "fair value" of the stock options to which



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ED, Appendix A, Amendment to Statement 123, Paragraph 17; Appendix B, Implementation Guidance, Paragraph B2. Since our stock options are not freely tradable or transferable, and there is, therefore, no "observable market price", the ED would require use of an options pricing model to determine value.

The ED declines to specify any acceptable or preferable option-pricing model by name, but rather specifies the factors that must be included in the option-pricing model used. This is understandable since none of the available option pricing models for market-traded options is suited to the task of enhancing transparency and improving the quality of financial statements. However, the proposed amendments to Statement 123 and the Implementing Guidance in Appendix B make it clear that the lattice/binomial model and the Black-Scholes model are the best the FASB can find.

These models are inadequate for a number of reasons. First, they are designed to value radically different types of financial instruments and have never been proven to serve as a suitable model for non-market/non-transferable instruments like stock options.

Second, the use of these models to produce expense numbers will result in a lack of uniformity and transparency. No matter how much effort goes into producing quality numbers, the number of assumptions and the range of choices within those assumptions would impair the comparability of these numbers and undermine the usefulness of the financial statements. While the FASB may not concern itself with the integrity of these numbers, issuers and investors will struggle to make these numbers relevant in the absence of greater uniformity. The more financial statement users understand about the means used to develop stock option compensation expense numbers, the less they will view them as comparable or reliable.

Black-Scholes is an empirically based mathematical formula used to determine the theoretical value of *market-traded* options. The lattice model may be a more complex approach to valuation, but it is designed and used for the same purpose as Black-Scholes. Market-traded options were created for trading. By design, they are simple financial instruments. Black-Scholes and the lattice option pricing models were developed to value these simple, short-lived trading instruments. These models assume that there is a liquid market for the instruments – that traders, hedgers, arbitrageurs and speculators will be ready buyers or sellers based on changes in the market for a given option. The models also assume that the instruments themselves:

- are freely transferable at any time;
- have a life that is fixed and measured in days, weeks or months; and
- can be hedged against with the underlying security.

These assumptions, used to develop a value for market-traded options, simply do not apply to employee stock options. If stock options must be valued at model-based fair value at their date of grant, then FASB should offer implementation guidance regarding models that it knows are designed and tested for the purpose of valuing "non-marketable/non-transferable" stock options.

B. Employee stock options are unique financial instruments, which are not comparable to market-traded option contracts.

Stock Options are designed for a completely different purpose than market-traded options. Stock Options are intended to motivate employees to bring a heightened sense of ownership, purpose and focus to their work. Stock Option terms vary greatly among the companies that issue them because companies' boards have different approaches to accomplishing this important, but sometimes elusive purpose.



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No market exists for our stock options. Indeed, the very concept of fair value is strained with regard to stock options because there are never buyers or sellers, only grantors and recipients. For the vast majority of option grantees – those who receive options under broad-based plans – no bargaining takes place. Furthermore, the employee does not own the option until he or she has met all the option's conditions, including remaining employed for a multi-year vesting period. Thus the employee "buyer" has no immediate claim to the option and no other person can ever have a claim, because they are not transferable. And the employer "seller" requires only continued employment for which the person is being paid separately. Imposing a fair value concept of a current transaction of willing parties on such an arrangement is to require not just a fiction, but a fallacy. While there is little experience to date, every indication shows us that the market would assign a value of zero to stock options like stock options, that are non-transferable, non-vested, with an at-the-money option. At least some prospect for a market should exist before application of the concept of fair value is presumed to be feasible.

The following characteristics further distinguish stock options from the types of instruments that option-pricing models are designed to value. Unlike tradable options, most stock options are:

- forfeited if an employee leaves the company before the option vesting date;
- subject to cancellation, if an employee is involuntarily terminated;
- non-transferable;
- subject to restrictions even after vesting;
- not hedgable;
- long-term lived;
- usually exercised prior to expiration; and
- exercised based on decisions that are external to operations of the company.

Therefore, anyone relying on the value of a stock option, derived from one of the ED's chosen methods, faces the distinct disadvantage of knowing that these "oranges" were valued as if they were "apples." Moreover, further investigation into the application of these models to stock options demonstrates conclusively that the values reached would be based on the type of speculation that does not belong in financial statements.

C. Use of the lattice or Black-Scholes models to value stock options will introduce assumptions and predictions into the financial statements that will impair comparability and usefulness for investors.

The option pricing models are highly sensitive to estimation of three key variables:

- expected volatility of the underlying stock;
- risk-free interest rate; and
- expected life of the option.

These kind of inputs can be predicted with some accuracy over periods of days or months; therefore, option-pricing models are useful for typical market-traded options. However, over the long lives of stock options such predictions are hazardous. The only certainty is that these assumptions will be proven wrong. The obvious question is then "what is the margin of error?" And the only honest answer is, "we don't know." Therefore, under the ED, companies will be required to make predictions about stock price volatility, interest rates in global capital markets and the options themselves, despite the fact that they can have almost no confidence in those predictions. This means, of course, that ASML's senior executives must somehow certify that these assumptions reflect a "proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transaction."



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D. The absence of guidance on a number of key implementation matters would further diminish the accuracy, comparability and consistency of financial statements.

The proposed amendments offer no guidance on a number of key implementation matters because none is available. FASB's failure to address these issues further diminishes the accuracy, comparability and consistency of financial statements for U.S. companies.

Companies implementing the ED's proposed changes will need to answer a number of questions for which there is inadequate guidance in valuing stock option. Among these questions are:

- variance of stock price volatility levels for multiple expected option terms;
- method of forecasting volatility using actual historical and/or implied levels of volatility;
- method of estimating expected life of the option as predicting future employee exercise behavior is difficult in the semiconductor industry;
- risk-free interest rates over a long term for multiple expected option terms.

The ED's proposals would greatly complicate the work of companies that must prepare financial statements. They would also impede the transparency and usefulness of financial statements. FASB's proposal suggests that the absence of a well-designed model for valuing stock options is a situation that can be remedied by the valuation profession. However, the ED presents more than mere challenges for valuation professionals, company executives and auditors. It presents a requirement to develop highly speculative numbers that will reduce net income, basic earnings per share and diluted earnings per share *as reported to investors under GAAP*. It will require financial statement preparers to expend significant time and resources to make their best effort to provide the best inputs available to the required models. Still, they will know that they are following FASB's requirements toward a number that they do not believe is accurate or an appropriate presentation of the options grant transaction.

While company executives, financial analysts and sophisticated investors will know to disregard the number, others will not. Therefore, it is highly likely that the net effect of this new accounting standard would be to limit the use of stock options in order to avoid the counterproductive burden that the proposed amendments would impose.

When a proposed standard creates such a burden and such an unreliable result that it runs a significant risk of changing the very culture of reporting companies, it is prudent to stand back away from the politically charged rhetoric before proceeding. The absence of a workable valuation model for non-market/non-transferable stock options is the most critical flaw in this proposal. We agree that the trust in our public companies has been badly shaken by a few bad examples – but it is important to point out that the FASB going to extremes to prove a point and win for the sake of winning will not result in better corporate governance, financial comparability, transparency or accuracy. Prosecuting the bad guys and bringing them to justice will.

Issue 13: Transition

The current ED states that public entities and nonpublic entities that used the fair-value-based method of accounting under the original provisions of Statement 123 for recognition of pro forma disclosure purposes should also apply the provisions of the ED in recognizing compensation cost for any portion of awards granted or modified after December 15, 1994, that is not yet vested at the date this ED is adopted. If the FASB pursues these amendments, we would highly recommend to align the transitional provision with the transitional provisions of IFRS 2. IFRS 2 should be applied for stock options granted after November 7, 2002 and had not yet vested at the effective date of the IFRS. The current ED will create confusion to our investors. As ASML is both stock quoted on Nasdaq and Euronext, we will have to publish our consolidated financial statements in accordance with U.S. GAAP and IFRS from January 1, 2005.



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Different transitional provisions for applying the fair-value-method of accounting for our stock options will not enhance the transparency of our financial reporting towards our investors and thus so, not support greater comparability between U.S. GAAP and IFRS. In addition, if the FASB pursues these amendments, we recommend to only effectuate this ED for financial reporting on fiscal years beginning after January 1, 2005 as this will increase volatility in 4th quarter financial results of 2004 as compared to previous quarters in 2004.

Issues 17: Differences between This Proposed Statement and IFRS 2

We understand that one of the reasons for issuing this ED is achieving greater international comparability in the accounting for stock options. In February 2004, the International Accounting Standards Board (IASB), whose standards are followed by companies throughout the world issued International Financial Reporting Standard (IFRS) 2, Share-based Payment.

Beginning in 2005, the European Commission will require companies that are quoted on a European stock market, such as Euronext Amsterdam N.V., to publish their financial statements in accordance with IFRS. While we intend to continue publishing U.S. GAAP financial statements, we also will publish our consolidated financial statements in accordance with IFRS from January 1, 2005. If the FASB pursues the amendments proposed in this ED, there will still remain differences with IFRS. It might occur that the compensation expense presented to our investors under U.S. GAAP differs from the compensation expense under IFRS. As a result, we believe that the current ED will create confusing to our investors and not enhance the transparency of our financial reporting towards our investors. In order to be transparent to our investors, we would recommend to provide us the option to account for stock option grants using the intrinsic value method under U.S. GAAP.

III. CONCLUSION

The ED will not increase transparency of our financial reporting towards our investors. We do not claim that accounting for stock options under the current accounting model is easy, but we believe that current rules do so as effectively as possible.

ASML appreciates the opportunity to submit these comments and is available, through our designated representative, to participate in one of the scheduled public roundtables.

Sincerely,

Peter T.F.M. Wennink
Executive Vice President and Chief Financial Officer ASML