



June 23, 2004

Letter of Comment No: 4128
File Reference: 1102-100

Financial Accounting Standards Board
Director of Major Projects – File Reference No. 1102-100
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

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

EXECUTIVE SUMMARY

Accounting for equity based compensation (EBC) has been in need of improvement for many years. The flaws in current accounting for EBCs create inconsistencies and asymmetries across the board. While there are many reasons for the flaws, the politically charged belief that the blame lies with executives unwilling to give up their ill-begotten compensation is backward and unproductive. In reality, the current state of affairs has more to do with the inherent complexity of measurement; there are no easy answers for valuing a non-transferable, forward looking option for at-will employees. Given these valuation issues, we propose a more reasoned approach to this debate to ensure that the valuation methodologies are improved and refined before discussing a full integration to the profit and loss statement. Rushing to a complex and still flawed expensing solution is not the answer.

Background on KLA-Tencor

KLA-Tencor is a \$1.4 billion semiconductor equipment company with approximately 5200 employees worldwide. Over 90% of our options are granted to non-executive (top five) employees and all of our employees in good standing hold options. We also have a broad-based ESPP with 86% participation worldwide. While we encourage and recommend diversification to all of our employees, we are proud of our employee ownership through the ESPP, options and 401K.

KLA-Tencor does not currently have the ability to issue any equity based compensation other than at-the-money stock options. We will need shareholder approval for a revised stock plan to allow other forms of equity based compensation.

We have added additional quarterly disclosures in our footnotes to help investors understand the impact of all of our equity compensation plans. We have tried to make this disclosure as transparent as possible in terms of the potential long term dilution effect of options. We have tried to present our disclosures in a fair and reasonable manner, making reasonable assumptions to value the options expense on a pro forma basis. However, in valuing options using traditional valuation methodologies, we have found many issues of inconsistency between

our peers, particularly in choices of assumptions for key variables which have material impacts on relative valuations.

While we applaud the FASB's attempt to provide more guidance and clarity in this area, we believe that the Exposure Draft as written falls short in several critical areas which we will discuss below.

“Transparent Accounting”

The first issue asked is whether options are an expense – i.e. is an opportunity cost an expense?

Every day, executives of public and private companies make decisions that have long-term material impact on the shareholder value of their companies. In some cases, they decide NOT to do something, in other cases they choose TO do something. Accounting does not try to capture the opportunity costs/benefits of these decisions at the time they are made. Instead, accounting reports on the impact of these decisions over the long haul as revenues are generated, expenses are paid and profit is made/lost. To be more specific, let us say that a company is deciding to hire 200 people to go into a new business with a small likelihood of being a huge success (10%), a larger likelihood of being a medium success (50%) and the residual probability of being a huge failure (40%). If we could value that decision for the shareholders at the time it was made, we could give them a to-the-minute view of the value of the corporation. In fact, if the executives made a decision with lower shareholder value than another available alternative, we should actually show this as an “expense” or opportunity cost of bad decision making.

In reality, this is impossible to do – too many estimates are involved and there is too much room for manipulation. Also, since the company could change its mind and lay off the 200 people the following quarter as the outlook changed, trying to revalue this opportunity would be too burdensome and again too prone to manipulation.

The options debate has direct analogies to the example above. By trying to be 100% accurate for the shareholders, the FASB is attempting to declare victory in the **wrong battle (expensing)** when their true focus should be on other issues (**valuation and transparent disclosure**).

The debate about whether options are an expense is less important than whether the disclosure system impedes our ability to create shareholder value by making the disclosure more difficult to understand and less transparent. Bad valuations are misleading; bad valuations where the inputs are too complex for anyone to actually untangle are worse.

Although we believe the public policy issues linking innovation and stock options are critical to the technology industry of the United States, we will instead focus on two other areas of difficulty inherent in the Exposure Draft proposal: valuation and implementation.

KEY ISSUE 1: VALUATION

As mentioned above, KLA-Tencor experiences and struggles with the valuation dilemma every time we put together a footnote for a 10-Q or 10-K. How much more difficult will this be when we must make general ledger entries on an option by option basis where **accounting decisions** today can result in very different **accounting outcomes** tomorrow no matter what happens with the actual underlying options?

The key valuation issues are:

1. Grant date valuation inadequacy for at-will employee options;
2. Inapplicability of any "market value" valuation technique on non-transferable options; and
3. Difficulty in achieving consistency in key variables in models.

Premise 1: Grant Date Valuation is Inevitable but Still Inappropriate

It is unclear why the proposal does not try to get to a more economic solution rather than just winning a political point. If you accept that options are an expense then the expense at the time of vesting is the opportunity cost of the options at that time – the company can decide to terminate the employee up until that time and not vest. If the options are significantly "in the money," the decision to keep the employee is costly. If the options are underwater, it does not cost the company much to keep the employee. However with the proposal as made, it would cost the company the same.

You have asked whether we believe that the proposal of (1) allowing valuation adjustments for early termination/early exercise and (2) only expensing the number of options vested, adequately adjusts for the issue of non-transferability and vesting requirements. We would argue that while it is a step in the right direction to recognize the inherent inability of a market-based valuation methodology to value employee options, it is not sufficient to put only minimal discounts on the grant date value rather recognizing our follow-on point, that option value at time of grant equals zero.

Corollary Number 1: Value to Employees at Time of Grant is Zero

The reasons employers issue options are primarily retention, alignment and last but not least, compensation. There are other forms of compensation that can achieve these two other goals, but in a less symmetrical way for the shareholders. With restricted stock grants, the employee can end up richer even if the shareholders end up poorer. The same is true with cash bonuses. Also, once the option vests, the employee is economically better off to continue to invest in the company (not exercise early). As KLA-Tencor employees demonstrate with a 5.5 year average life on options, many of the employees do just that – which is not available with cash bonus plans.

But at the grant date, how does the employee value the option? As a major Wall Street derivatives trader stated quite succinctly in a presentation at our company – value at grant

equals zero - only complete transferability, ability to hedge and guaranteed vesting give the option value. These do not exist for employee options.

Premise 2: Estimates are the Drivers, not Underlying Fundamentals

Already, KLA-Tencor has engaged with valuation consultants and our auditor on issues related to key assumptions in the lattice model. The literature on this is scant or non-existent. The outcome of the debate could increase/decrease the options expense by a factor of four. Just the volatility assumption alone has a range of +/- 25% between implied and historical - not a minor input in the valuation model. Early exercise assumptions are also significant – our experience so far with regression models to determine early exercise behavior suggest that there will be wide variation in practice in developing and using these models. Insufficient practical experience exists for determining these numbers.

Will the unpredictability and inherent inaccuracy of these estimates eliminate any transparency benefit that the FASB hopes to gain by putting the expense through the P&L? Because this exposure draft is a laboratory product without adequate field testing, it is impossible to answer that question. More actual field testing and actual work with valuation consultants, audit firms and reporting companies would result in better working guidance to ensure consistency and compliance.

KEY ISSUE 2: IMPLEMENTATION

The requirement for more field testing also points to additional implementation issues; the key ones that we would like to discuss are:

1. Potential for phased-in pro forma reporting;
2. Ability to restate historical financial statements; and
3. Burdens of new requirements in coordination of new requirements with Sarbanes-Oxley certifications.

Phased-in Pro Forma Reporting

When the semiconductor equipment industry implemented SAB 101 in 2000, we changed our accounting principles to conform to the new guidance. We did not do pro forma reporting on a shipment basis because the delta between shipment and acceptance could be easily tracked by investors through the deferred profit account.

As currently proposed, the options expense, although not a cash expense, will be “hidden” among many different lines of the profit and loss statement. The compensation expense will be allocated between gross margin and operating expenses. The tax aspects will be part of the tax rate. The reconciliation of the expense can be recreated and explained outside the P&L, but the actual P&L will not be transparent.

As proposed, companies will create their own “pro forma” accounting to eliminate the volatility related to equity based compensation expense. We agree that in the past, pro forma has been abused and GAAP has prevailed. History, however, does not always foretell the future, and in this case, investors might find the pro forma reporting more clearly represents the operating activity and future prospects of the enterprise making GAAP less relevant.

Ability to Restate

To ensure comparability across periods, any proposal should allow for restatement of historical results. The FASB rationale in this area is unclear and insufficient.

Coordination of Implementation with Sarbanes-Oxley

The public and private accounting profession is over-burdened today with complying with new Sarbanes-Oxley requirements. If the FASB polled many reporting companies, they would find that their service providers are in some cases raising hourly rates to “market driven levels” and in some cases, turning down new clients due to lack of resources. While we have not experienced this first hand, the task of complying with 404 at the end of our fiscal year ending June 30, 2005 while preparing to comply with the Exposure Draft at the same time is daunting. In particular, our chief executives must certify as to the accuracy and fairness of our calculations on the valuation of stock options where the assumptions used are so critical to the final calculation. Can the Chief Financial Officer predict the volatility of the stock fairly for 3 months, 6 months, 12 months, 24 months, etc.? One wonders when the chief executives will have time to actually make business decisions.

OTHER ISSUES

Tax

The current Exposure Draft proposal for accounting for deferred tax assets is extremely inconsistent and punitive in two aspects:

- the write-off of unrealized deferred tax assets directly to the profit & loss statement directly even if the benefit will be realized later through use of NOLs and
- the treatment of excess tax benefits as financing cash flows instead of operating cash flows. If the options giving rise to the tax benefits are compensation expense, then the excess tax benefits should be operating cash flow.

ESPP

KLA-Tencor's ESPP plan has 86% participation worldwide. While we have been prepared to revise this plan to a minimal discount plan which may result in fewer employees participating,

the current proposal does not allow even for a minimal discount. Our position remains that a minimal discount of 5% should be allowed as this is approximately the cost of issuing comparable amounts of equity in the market. If the proposal stands as written, it will result in lower employee ownership in companies and potentially lower savings rates as this program is another form of savings plan for many employees.

SUMMARY

The FASB would do more toward its mission of "improving standards of financial accounting and reporting" by a more reasoned approach to reporting equity based compensation. If these proposed amendments become accounting standards, accounting will become less transparent, less understandable to non-professionals and less relevant.

KLA-Tencor appreciates the opportunity to submit these comments and to participate in one of the scheduled public roundtables.

Sincerely,

A handwritten signature in black ink, appearing to read "Maureen L. Lamb". The signature is fluid and cursive, with the first name being the most prominent.

Maureen L. Lamb
Vice President, Finance