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VIA E-MAIL AND OVERNIGHT COURIER

Financial Accounting Standards Board
MP&T Director
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Invitation to Comment, Accounting for Stock-Based Compensation: A Comparison of FASB Statement No. 123, and IASB Proposed IFRS, Share-based Payments.

Dear Sir or Madam:

On behalf of the Semiconductor Equipment and Materials International (SEMI), we submit these comments to the Financial Accounting Standards Board (FASB) in response to the above-referenced November 18, 2002, Invitation to Comment. We appreciate the opportunity to offer our views on this critical accounting issue.

SEMI is an international industry association representing more than 2,500 companies involved in the semiconductor and flat panel display equipment and materials markets. SEMI maintains offices in Austin, Beijing, Boston, Brussels, Hsinchu, Moscow, Seoul, Singapore, Tokyo and Washington, D.C. Through its international scope, SEMI sees the impact of broad-based stock option plans on innovation, productivity and U.S. leadership in global technological advances. Three-quarters of employees in our industry receive stock options, and 86% of those options go to workers below the executive management level. Therefore, SEMI's members have a significant stake in insuring proper accounting for stock options.

SEMI is pleased to comment on the issues presented by the proposal. We recognize that the FASB does not wish to consider economic or policy matters in this request for comment. However, since these issues are of enormous import, we resubmit as Attachment A or comment on Proposed Statement," Accounting for Stock-Based Compensation – Transition and Disclosure" (File Reference No. 1101-001), which reviews the compelling economic and policy reasons for maintaining current U.S. accounting for employee stock options. While we believe the FASB should be very mindful of the importance of the way accounting treatment can change economic behavior, we will confine our comment in this letter to accounting issues.

I. The current U.S. standard on accounting for employee stock options, SFAS 123, October 1995, represents sound accounting.

Current accounting for stock options provides investors with a wealth of information about the potential impact of employee stock options on the interests of shareholders. Additional disclosures, both those mandated by the SEC and those provided voluntarily by companies, give investors information about stock options that are based on current facts. For investors who believe stock options should be a corporate expense, footnote disclosure provides the key numbers – model-based expense calculations and their impact on net income and on earnings per share. To use the criterion stated in Page 10 of this Invitation to Comment, this is "decision-useful" information. It is useful because it is clear from their presentation what the numbers are, and what they are not.

No investors have been misled by the current intrinsic method of accounting supplemented by disclosure on a fair value model. While we understand that accountants do not like alternative presentations, intrinsic value accounting with extensive footnote disclosure of fair value accounting and its impact fairly and accurately accommodates the two competing views of the nature of employee stock options. It also avoids the uncertainty that hypothetical assumptions built into model-based fair value numbers would create, if not thoroughly explained in the financial statements and footnotes. Critics of current U.S. accounting often overlook the extensive information available to the markets and investors. Indeed, their criticism tends to focus more on governance concerns and executive compensation aspects of stock options accounting – not a lack of transparency under SFAS 123.

As William Sahlman writes in "Expensing Options Solves Nothing," Harvard Business Review, December 2002, "...reporting an executive option as a cost item on the income statement does not add any information that's not already included in the financial statements. If anything, expensing options may lead to an even more distorted picture of a company's economic condition and cash flows than financial statements currently paint." SEMI believes that current U.S. GAAP treatment of stock options provides all parties – investors, managers, employees and analysts -- sufficient information to understand the impact of employee stock options on the business. To require an expense for stock options will lead into new, arcane accounting that will surely result in more *pro forma* accounting to remove the misleading overstated non-cash charges based on a highly flawed model.

II. The only "cost" of issuing employee stock options is borne by existing shareholders in the form of potential dilution.

While the FASB does not request comment on this issue, we must note that it is an accounting issue, not an economic matter. It is also the fundamental question on whether the FASB standard is generally accepted or not. It is obvious that employee stock option grants result in no cash cost to the company. Current accounting fully discloses the impact of employee stock options in the form of diluted earnings and diluted earnings per share. Subtracting a non-cash expense from the numerator of the EPS ratio counts twice the impact of option grants.

FASB only recently decided to eliminate automatic goodwill expensing in business combinations – in part, because it was an expense that did not align with the reality of the

business. Therefore, we believe that the FASB is significantly premature in closing its collective mind on the question of whether an employee options expense, with all its limitations, should really be counted as a cost to the corporation.

The argument that has been most firmly cited by expensing advocates in the past is that employees see stock options as compensation. Recent academic work contradicts this view. *In the Company of Owners*, a book by Professors Joseph Blasi and Douglas Kruse and Senior *Business Week* Editor Aaron Bernstein, concludes that employee stock options are not compensation, but capital income. This view supports the point that many SEMI members have made for years: options are not intended to compensate workers for services performed. They are intended to motivate them to think like partners in the enterprise and to bring an owners perspective to their work.

While many people disagree with this major premise, the fact that corporate managers and boards of directors firmly believe it to be true, should be reason enough for the FASB to adhere to its current standard, which reflects the unresolved debate on this very issue. There are two valid and fundamentally different views of the nature of the options grants. Current treatment accommodates these differing views in a way that provides investors all the information they need to evaluate the effect of stock options on the financial condition of the company. No more is required.

III. Requiring an expense based on fair value estimates will diminish the reliability and transparency of financial statements as compared to current accounting.

The elimination of intrinsic value accounting for stock options would require a compensation expense at fair value for employee stock options at grant date. This proposed standard involves a decision to call a capital transaction a compensation expense, an incorrect decision as we noted above. It also involves fixing the expense at a time when the real cost, even in the form of dilution, is unknowable, precluding any opportunity to adjust it to the ultimate reality. Finally, it requires companies to treat an incorrect and misleading number as an expense in the income statement. Any one of these flaws should be sufficient for the FASB to reject modification of SFAS 123. The proposed change will not increase financial statement reliability, transparency, or comparability. Indeed, the inclusion of demonstrably wrong numbers in the financial statements will harm these three key elements of good financial reporting.

Assuming options ought to be expensed as compensation, it is still unsound accounting to require companies to book that expense. At the heart of the issue is the lack of any useful basis for placing a value on the options. Requiring an expense based on currently available models will harm reliability, comparability and transparency.

A. Reliability

Fundamental problems exist with application of current option pricing models to employee stock options. Current option pricing models cannot properly measure the corporate cost or "expense" associated with issuing employee stock options. Inclusion of this expense in financial statements -- as contrasted with the intrinsic value and footnoted fair value of current

treatment – will add a number which no one believes is accurate, without any explanation as to its limitations.

Many of SEMI's members have broad based option plans and volatile stocks. This is true of most companies in cyclical, high technology industries. As is easily seen in the SFAS 123 footnotes of these companies, the impact of an expense based Black-Scholes or other existing option pricing models can be significant, probably large enough to influence a decision to buy, sell or hold the stock. Yet these option expense numbers are highly unreliable, reflecting assumptions and ever-changing facts. To move these numbers up in the expense section and incorporate them into cash compensation will clearly affect the reliability of the financial statements for just such decisions – particularly by the average investor who looks primarily at net income and earnings per share as measures of corporate performance.

We believe the FASB's failure to request comment on the measurement issue ignores many years of further study, since the FASB last considered full public comment on the question. At the time SFAS 123 was adopted, FASB believed that current option pricing models were an adequate way to value employee stock options. The data that has been developed since SFAS 123 was adopted shows that while FASB may have believed then-current pricing models were adequate, they are not.

We disagree with the assertion that current option pricing models, adjusted for factors they were not designed to consider, provide reliable financial data. Many of the unique aspects of employee stock options are not accounted for in these models. For example, the assumption that stock options are freely transferable is inherent in all option pricing models. This is not true with employee stock options. This fact is one of the basic flaws that is not considered in the FASB's work on the subject of employee stock options expensing.

Exchange-traded options derive much of their value in option pricing models from allowing investors to trade easily in and out at efficiently determined prices, as their view of the market changes. Thus, the Black-Scholes value increases with higher volatility because this increases the upside potential of the tradable option. With non-transferable options, employees have no opportunity to take advantage of volatility until they exercise and assume the risk of equity ownership. This is, at least, one reason why employees tend to exercise their options before the expiration date of the option.

Option theory can demonstrate that options should only be exercised on the last day prior to expiration. This is because, at any time prior to that date, the option has a value greater than could be obtained through exercise. The fact that all option models reach this same conclusion, but employees most often exercise their options with many years remaining on the options, clearly indicates that employees use different valuation measures than option pricing models. This behavior reflects valuation decisions by employee option holders that are due to the lack of transferability and other inherent differences between employee options and freely traded options.

Employees face, for example, the chance that they may be terminated during an industry slump, restricting the employee's opportunity to exercise at a time when the underlying stock will have a very low value. This is reality in our very volatile industry. No reasonable estimate

of the impact of this fact has been offered, yet this is a significant difference between long-term, non-transferable options in the hands of employees and short lived, freely tradable options in the hands of option traders.

B. Comparability

Models such as Black-Scholes allow for large differences in the ultimate stock options expense for a given period depending upon the assumptions built into the model. Interest rates, dividends, and employee behavior also have to be predicted, opening up opportunities for widely different results from similar companies with different views of the future.

The volatility variable poses the greatest burden on comparability of different financial statements. Relatively small changes in volatility assumption can change the expense significantly. Any reduction in reliability of an expense entry reduces the reliability of the entire financial statement.

In order to avoid problems of comparability, sophisticated investors and stock analysts are planning to "back out" the options expense numbers. Morgan Stanley Equity Research, *Options: Separating the Cash from the Rash*, November 13, 2002, p. 9. The Morgan Stanley analysts who cover this industry note that, while institutional investors will be able to adjust income statements for options expenses, "individual investors would be the most confused by options expenses." *Id.* This confusion would result directly from the use of option pricing models for determining the fair value of a highly questionable expense.

C. Transparency

As noted above, the current accounting treatment and presentation of employee stock options provides ample information to investors. As also noted above, much of the transparency of this information will be lost if stock options are merely lumped into a compensation expense category, indistinguishable from real cash expenses and other real claims on company cash flows.

This lack of transparency can have real consequences for all investors as increased volatility in expenses due to option grants creates volatility in reported earnings and volatility in share prices. Certainly, these effects are not among the goals of good accounting. One might argue that this won't occur because investors will look away from reported earnings toward other measures of cash flow -- hardly an indication that the change improves accounting for any practical accounting purpose. The only other reason that greater volatility would not occur is that companies will curtail their use of options. While this might please those who oppose employee stock options as policy, it would not be a result that the FASB should want to claim.

III. Conclusion: FASB should conclude its review of this issue.

The current U.S. GAAP treatment of stock options most clearly reflects the reality of the transaction, and the two differing views of reality in a decision-useful way -- a way that the average investor can understand. It is a successful standard by this most reasonable of criteria. There are a number of more critical accounting matters demanding the FASB's attention.

Expensing employee stock options will not eliminate the use of shell games to hide significant risks and expenses. Employee stock options are not the cause of management or auditor malfeasance.

Current accounting for options has achieved reliability, consistency and transparency. These ideals are not served by moving a dubious computation from the footnotes to the face of the financial statements. Indeed, the average investor will be the loser. Financial statements will have fictitious charges that will materially misrepresent current period performance. Investors' confusion will promote a continued decline in the usefulness of GAAP financials and the importance of *pro forma* reporting. The current standard is the right accounting for stock options.

SEMI appreciates this opportunity to contribute to the FASB's deliberations and stands ready to assist in any way.

Sincerely,

Victoria Hadfield
President, SEMI North America

November 4, 2002

Financial Accounting Standards Board
Director of Major Projects and Technical Activities
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

Re: Proposed Statement, "Accounting for Stock-Based Compensation – Transition and Disclosure" (File Reference No. 1101-001)

Dear Director:

On behalf of the Semiconductor Equipment and Materials International (SEMI), we submit these comments to the Financial Accounting Standards Board (FASB) in response to the Exposure Draft on Proposed Statement of Financial Accounting Standards, Accounting for Stock-Based Compensation – Transition and Disclosure, which was released on October 4, 2002.

SEMI is an international industry association representing more than 2,500 companies involved in the semiconductor and flat panel display equipment and materials markets. SEMI maintains offices in Austin, Beijing, Boston, Brussels, Hsinchu, Moscow, Seoul, Singapore, Tokyo and Washington, D.C.

We commend the effort by the FASB and other national standard setters to make financial statements more consistent and to increase clarity to investors. However, we are concerned that some aspects of these amendment to FAS 123 will have unintended consequences as a result. That is the basis for the submission of these comments.

Stock options have been one of the most important contributors to the success of the semiconductor and high-tech industries. In this highly technical and intensely competitive industry, stock options have been an essential tool for leading companies to retain the key talent they need to remain competitive and for start-up companies to attract the talent they need. Ample evidence exists to correlate the positive relationship between employee ownership of stock and a company's productivity and success. Owning stock options allows employees to be part owner of the company and benefit directly from the fruits of their labor. FASB should not threaten this mutually beneficial relationship.

In August 2002, SEMI conducted a survey of its U.S.-based public member companies which revealed that 74 percent of industry employees receive stock options, and that over 86 percent of the total options granted go to workers below the executive management level. If required to expense their stock options plans on financial statements, these companies may be forced to curtail the number of options that they offer. The survey respondents collectively represent a total employment base of over 31,500 industry

workers and combined annual sales of $13 billion.

I.More Meaningful Disclosure Requirements

SEMI supports meaningful new quarterly disclosures of options plans. We believe that the appropriate way to protect shareholders is not by requiring the expensing of stock options, but by ensuring full disclosure of option plan information. This should be carried out quarterly in a transparent format that aids investor understanding. The SEC's recently adopted disclosure tables and voluntary enhanced disclosures by some companies are good examples of the type of information investors should have on a more timely basis. SEMI companies endorse best practices such as maintenance of broad based options programs, shareholders approval of executive option plans and adherence to standardized disclosure reporting format. Therefore, SEMI endorses the FASB proposal to require standardized pro forma disclosure in a tabular format.

The current practice of providing information about stock options once per year has proved insufficient. Investors, particularly institutional investors, have sought more frequent disclosure. All investors are entitled to the best information that can be produced in a cost-effective and understandable format. However, as explained below, we believe that periodic disclosure of fair value expenses, based on currently available measurement methods, and their impact on net earnings and earnings per share will not enhance the value of information for shareholders.

II. FASB's Proposal on Periodic Reporting Will Generate Investor Confusion Due to Valuation Problems

Central to FASB's proposal is the requirement for a company to provide investors with more accurate information about its financial status. While we approve of efforts to provide more and better information to investors about stock options on a quarterly basis, we see this proposal as accomplishing the opposite. First, treating the grant of stock options as an expense to the company as though it represented either a cash outlay or a liability to pay anything in the future is simply wrong. If there is any cost to the company it is a theoretical one and its disclosure annually in footnotes is sufficient. More frequent disclosure will only raise greater risk that investors will be confused or, worse, misled.

This "expense", under SFAS 123 fair value treatment is a based on theoretical calculation for which no real-world validation exists. Indeed, the Black-Scholes or binomial models, which were not designed to measure such expenses, produce results that are clearly wrong. The only question is whether they are (1) marginally useful as separate numbers (in footnotes), (2) useless, but safely discounted in footnotes or (3) so wrong as to be misleading. We believe that the requirement to provide the theoretical impact of fair value, model-driven numbers will, in fact, lead to investors lending greater credence to this misleading and confusing information.

Therefore, the FASB has struck an appropriate balance in permitting companies to adopt fair value accounting based on their own views as to the best of the methods described in the Exposure Draft.

Conclusion

While we support meaningful reforms to the disclosure and accountability on stock options, we do not want to see broad based stock-based incentives threatened and therefore, we do not support amending FASB Statement 123. We believe that the current model of FAS 123 should remain in place. Specifically, SEMI believes that full disclosure is preferable to expensing because of the theoretical nature of the expense and because no valuation method exists today that can provide shareholders with accurate and reliable numbers. Because of the unavailability of such numbers, we oppose the proposed inclusion of *pro forma* results in periodic reports. However, should the FASB decide to mandate expensing, we believe that companies should be given flexibility in deciding how to phase in the expense.

Thank you very much for providing the comment period and we appreciate the opportunity to share with you our industry's perspective on this matter.

Sincerely,

Victoria Hadfield
President, SEMI North America

There is an increasingly vocal chorus of companies, academics and financial experts who have raised concerns about the Black-Scholes model, especially as it relates to long-term employee stock options. These legitimate concerns must be considered by FASB before it lends greater credibility to Black-Scholes numbers. Representative of these concerns are those of Burton G. Malkiel, Professor of Economics, Princeton University, and William J. Baumol. Professor of Economics, New York University, in "Stock Options Keep the Ecomony Afloat," The Wall Street Journal, April 4, 2002:

> "The Nobel Prize winning Black-Scholes does an excellent job of predicting the prices at which short-term options trade in the market. But the Black-Scholes formula does not provide reliable estimates for longer-term options, such as those lasting six months to one year, and market prices often differ substantially from predicted values."

They went on to say:

> "Because employee stock options have durations of five to ten years, are complicated by not vesting immediately, are contingent on continued employment and subject to various restrictions, it is virtually impossible to put a precise estimate on the option's value. Moreover, employee options cannot be sold, violating one of the key Black-Scholes assumptions."

As the FASB is surely aware, the closer it moves toward mandatory use of fair value options expense numbers, closer scrutiny is leading to greater doubt about the usefulness of these model-based expense numbers to investors. As a disinterested party put it recently, with Black-Scholes expense numbers, investors "'are going to get irrelevant information that they'll use incorrectly.'" David Hilal, managing director of Friedman, Bilings, Ramsey, *quoted by* Howard Gleckman, "The Imperfect Science of Valuing Options," *Business Week*, October 28, 2002.

For these reasons, SEMI opposes the proposal to require quarterly disclosure of the currently mandated *pro forma* data on the impact of fair value options expenses.

III. Proposal on Transition to Expensing

SEMI does not believe that investors are well served by the voluntary adoption of the expensing approach in SFAS 123. Indeed, many companies that have elected to do so, still question the accuracy of the numbers they are required to use. However, for companies that do elect to expense voluntarily, we support the FASB's proposal to permit companies flexibility in the method they use for giving effect to the use of fair value accounting for employee options. As the Exposure Draft notes, neither comparability nor consistency would be possible even if all companies that chose to expense options did so. Such a trend is unlikely. The result of a recent Deloitte & Touche "Survey on Expensing of Stock Options" (September 27, 2002), show that the valuation issue alone will preclude many companies from deciding to expense.