

**Letter of Comment No:** 35  
**File Reference:** 1101-001  
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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 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.

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 Economy 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 employcc 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. Morcover, 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 Ifilal, 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. 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