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Re: ED-2 Invitation to Comment – Accounting for Share Based Payment

Dear Ms. Crook:

This letter addresses the ED-2 Share-Based Payment Invitation to comment. We are pleased that the invitation welcomes comments on any aspect of the exposure draft. This response will therefore cover some of the issues that are crucial for consideration in the final conclusions that might be obtained during your analysis of this particular issue.

There is one basic issue that should be of primary consideration in any decision on how share-based payment in regard to employee stock options (ESOs) should be treated for accounting purposes: what is important to investors to allow them to understand and interpret the financial information that is being presented. FASB issued Statement 123 with that goal in mind. At that time the FASB agreed with commentators who suggested that this new information was too complicated, too unproven, and too contentious to be placed within the financial statements. Therefore the information was included in the footnote disclosures to the financial statements. The situation is little changed today, as the standard requires computations that are still subject to disagreement within the corporate, accounting and investing community. It is clear that investors have not heeded the information on employee stock option expensing. Companies that adopted ESO expensing have not seen a large market reaction to this news. Likewise companies that have asserted their belief that expensing is not appropriate did not see large changes in their market valuation. The fact that investors have made limited use of fair value accounting is not a valid reason to elevate this dubious valuation directly on the face of the financial statements.

The opening objective stated in the ED-2 is to ensure that an entity recognizes all share based payment transactions in its financial statements, measured at fair value, so as to provide **high quality**, **transparent** and **comparable information** to users of financial statements. We respectfully submit that the expensing of

ESOs in a manner that would be consistent with the ED-2 accomplishes none of this objective for all of the reasons outlined in this comment letter.

We encourage the IASB to adopt the current U.S. financial accounting standard 123 and utilize the current disclosure standard as opposed to expensing ESOs. The support for this position can be broken down into two categories: 1) Accounting reasons that include lack of consistency, valuation flaws and lack of transparency. 2) Policy reasons that include competitiveness and fairness to our knowledge workers. While we understand that the IASB may not be interested in the policy reasons, we think those reasons are of importance to investors and overall economic growth and therefore they are included. We will first address the accounting reasons why ESO expensing is not appropriate, and therefore the U.S. generally accepted accounting principles under FAS123 current disclosure standard should be adopted, we will then cover the policy issues that play an important part in this discussion.

***Accounting Reasons Against Expensing ESOs*:**

Consistency – Accounting hallmark

Consistency has always been the watchword for accounting in the United States and we recognize the need for consistency within the European Union. Consistent treatment of an item between periods is essential to correctly reflect the financial condition and financial performance of the enterprise. Expensing of ESOs will not enhance comparability of financial periods. The Wall Street Journal reported on September 19, 2002 "…the options Cisco granted for the fiscal year ended July 2001 were valued at $3.3 billion. Today, using the same statistical model, those options would be valued at $131 million, because Cisco's stock price has dropped precipitously." These do not appear to be consistent results and in fact mislead investors. The current proposals for expensing do nothing to revalue ESOs, which have lost any portion of their value.

The current U.S. disclosure standard has been in effect for less than 10 years. There is no legitimate reason to abandon the standard, or aggressively push ESO expensing forward. Consistency between accounting standards between countries is an ambitious and worthy goal, however, no countries rushed to follow Statement 123 when it was originally adopted in the United States. In fact, some very large countries that are growing at very fast rates, like China, are not even within the accounting guidelines of either the FASB or the IASB. Now the IASB is pushing for standards on ESO treatment. We respectfully submit there is a great deal of work to be done before the IASB introduces their standard. Investors will be better served by the adoption of the current U.S. disclosure standard until it is clear what other standard setting boards adopt with regard to ESO accounting, and how broadly these standards are enacted and enforced.

Valuation Flaws

Both the FASB and the IASB call for companies to adjust their use of whichever option-pricing model they choose for factors that are distinctive to ESOs when compared to freely traded marketable options. The premise inherent in all option pricing models is that market participants are free to change their investment positions based on their interpretation of market data. This is not true with ESOs. Employees are not free to trade their options. This fact is the one basic flaw that is not considered in the work on the subject of ESO expensing. Options derive much of their value in option pricing models from free transferability which allows investors to trade in and out as their view of the market changes. In contrast an employee can only watch as the value of their options declines, having no recourse other than to leave their jobs and seek a new one. This is one reason why employees generally will exercise their options earlier than the final expiration date. Option theory can demonstrate that, in the absence of dividends, options should only be exercised on their last day of life. At any time prior to their expiration, the option has a value greater than could be obtained through exercise. Every option model created reaches this same conclusion concerning freely traded options. It should be instructive to the IASB that employees most often exercise their options with many years remaining on the options, clearly indicating there are different metrics of valuation in use by employees. These different metrics are due to the restrictions, lack of transferability and other inherent differences of ESOs from freely traded options. For example, the chance that employment may be terminated, cutting off the opportunity to exercise at exactly the time that exercise is likely to have the lowest value, is something that each holder of an ESO must consider. In a briefing conducted by Dr. Rory Knight of Oxford University, these and other valuation flaws are supported by hard data. This data found the Black-Scholes and the Binomial models problematic at best in the valuation of ESOs. These models do not take into account the trading restrictions as discussed above, "they do not deal with forfeitures, their design is for short-term instruments and each input is a random variable with a high margin of error". In an analysis prepared by A.G Edwards, October 29, 2002, *Biotech Stocks, Biotech Options, Whose Earnings?* , One of the key conclusions held was, " The Black-Scholes approach to expensing incentive options appears to be problematic to us, largely because it makes earnings subject to factors outside management's control such as share price volatility and the risk-free interest rate". That respected analysts can come to this conclusion is not surprising, but we find it astounding that accounting boards do not recognize and accept this very real flaw. No analysis has yet been put forward that can reasonably estimate that impact and consistently model how employees value a contract with these restrictions. In TechNet's comments to the U.S. FASB, November 4, 2002, Rick White, CEO of TechNet, emphasized the difficulties of valuation models for ESOs. "There is a growing consensus that current option pricing models, when applied to ESOs, produce wide-ranging and therefore often misleading results. Quarterly disclosures based on a flawed valuation will not serve shareholders or investors."

Transparency

Another accounting issue within the IASB's approach to ESO accounting is how comparability will suffer due to the many choices that companies have in the implementation of the expensing standard. The fair value approach has too many moving parts, each of which is subject to estimation and determination by the companies implementing the standard. These different choices create too much variability between the answers that derive from the fair value accounting method. Companies in similar industries, with similar capital structures, may choose different applicable interest rates, different expected option lives, and different volatility levels when applying their model to determine the "fair value" of ESOs. This is supported clearly in the same report mentioned above prepared by A.G. Edwards, October 29, 2002 *Biotech Stocks, Biotech Options, Whose Earnings?* The analysis clearly points to the difficulties and lack of comparability in the data. Risk-free rates that companies utilized varied. This is supposedly the most predictable of all of the inputs to the model. Increasing the lack of comparability are the adjustment recommendations to option pricing models required for ESOs. Transparency of financial statements will not be served by combining these inconsistent measures into a single figure for inclusion in an income statement, and this is not the appropriate approach to financial reporting. Instead these metrics should be retained in a prescribed footnote disclosure, complete with their details and explanations, so that investors can make their individual choices on how to use the information presented. Investors have generally chosen to ignore the disclosures, due to the inaccuracy that result from applying existing option models to ESOs. For this reason, stock option expensing should not be added to the financial statements.

Proponents of ESO expensing in the United States argue that expensing is needed to improve accuracy and reliability within financial statements. Expensing ESOs, however, would not have cured or prevented the fraud by corporate management in some spectacular bankruptcies that have recently shaken investor's confidence in financial reporting. Expensing ESOs will not eliminate the use of special purpose entities to hide significant risks and expenses. ESOs have been painted as the culprit in aiding and abetting management malfeasance. But ESOs were not the cause of the problems, and changing the accounting treatment does nothing but deflect attention away from the real issues of **consistency, valuation,** and **transparency**. These accounting ideals are not served by moving a dubious computation from the footnotes to the face of the financial statements. 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."

<u>Policy Reasons Against Expensing ESOs:</u>

Competitiveness

Investors primary concern when allocating capital is the returns they can expect from that investment. Companies that issue employee stock options have had better returns over a long period of time. A recent study presented in the book, "*In The Company Of Owners: The Truth About Stock Options and Why Every Employee Should Have Them*", Blasi, Kruse, Bernstein, (Basic Books, 2003), reported "on average, companies and their investors made a profit on partnership approaches including stock options, over and above any ownership they dished out to employees. They gave workers an 8 percent ownership stake, and in return enjoyed an average of a 2 percentage point higher return on the shares they still held." This study demonstrates that using broad based employee stock option plans to align the interests of employees and shareholder works. This view was also supported at the Lisbon summit in March 2001 and most recently in the Opinion of the European Economic and Social Committee on the *Communication from the Commission to the Council, the European Parliament, the Economic and Social Committee and the Committee of the Regions on a framework for the promotion of employee financial participation*. Section 7.2 in the conclusion of the opinion states:

> "The EESC would point out that financial participation is entirely consistent with the European Union's established objectives of social cohesion and economic development, and therefore advocates stepping up this instrument, by increasing knowledge about it and identifying current obstacles."

We submit that expensing ESOs on the face of the income statement is an obstacle to the achievement of this established objective. Instead of stepping up this instrument, companies will be forced to retreat. To expense ESOs would surely dampen economic growth and innovation. The facts show that companies with ESOs have outperformed companies where options are less widely distributed, thereby justifying their higher stock prices. The current U.S. GAAP standard under FAS123 provides information that investors need to determine the impact of stock option plans and investors have consistently decided that broad based ESO plans can be an important part of the success of a company. We again refer to a study as presented in, the Blasi, Kruse and Bernstein book. (Page 109), " The High-Tech 100 handed out 7 percent of their total equity to employees and the top five officers that year. (2000). The top five executives in each firm received just 1 point. To put it another way, the High Tech 100 granted 1.5 billion options in 2000. The top five officers got 164 million of these, while everyone else split the remaining 1.36 billion." This is the type of additional information that investors need to determine the impact of stock option plans. We believe that this information is so important that we recently participated in efforts to improve stock option disclosures on grants to senior management, in order to help investors understand that our company's employee option plan really is broadly based. We would ask the IASB to consider a disclosure-only approach, even if those disclosures are broader in nature than currently prescribed in the U.S. standard. In November 2002 TechNet and AEA, along with 33 companies including KLA-Tencor, released an improved approach to disclosure of executive options, to be incorporated into quarterly filings. According to AeA Chairman Richard C. Cook, 'including the expanded disclosures in company quarterly SEC filings would be a significant improvement over the way the information is currently provided." We have reported, and intend to continue to report, this information on a quarterly basis.

It is notable that international standards did not move to provide greater disclosure or expensing of options immediately following the FASB's decision in 1995 to require disclosure of fair value accounting. This indicates not just the controversial nature of fair value accounting; it also indicates that other countries realize the success and the invocation of the entrepreneurial spirit that can be created with ESOs. At the European Council meeting in Lisbon in 2000, Member States of the European Union set the goal of "making Europe the most competitive and dynamic knowledge-based economy in the world." This goal was to be attained by promoting the entrepreneur approach within their employee base and business communities via increased use of ESOs. The EU called for all member countries to introduce laws to encourage ESO plans. It is our understanding that the European Economic and Social Committee have recently, (26, February 2003) issued their opinion on a framework for the promotion of employee financial participation. The opinion in section 3.1.1 states, "A number of factors, linked to changes to the ways capital is allocated and factors of production are organized, have boosted the importance of human capital, facilitating progressively closer involvement of employees in carrying out the function of the enterprise. This greater involvement is paralleled by growth in employee participation in company economic results." Since the EESC has agreed that employee ownership is a vital part of economic success, it is hard to see how ownership will be encouraged if accounting practice undermines the objective. Taiwan has also made extensive use of ESOs to build their high-tech industry. "Taiwan company law stipulates that a percentage of company earnings must be shared among employees and that stock bonuses are earnings distributions and not company expenses," *Taipei Journal,* Taiwan December 5, 2002. Likewise China is expanding the use of ESOs in an effort to build alignment between workers and investors. According to *Business Week* December 9, 2002, China is encouraging "many U.S. based scientists, engineers and executives born in China to return home to found tech start-ups." These nations, two great competitors within the global economy, are not regulated by either the FASB or the IASB. We believe that the IASB as a social partner has a responsibility to consider the economics of the decision they have before them. As stated in Section 7.4 of the *Opinion of the European Economic and Social Committee:*

> “ The social partners have an important role to play here, determining forms of financial participation which foster greater sharing of company aims and boost investment in human capital, which are both key factors for European economic development.”

In determining that ESOs be expensed, the IASB will also determine that the ESO form of financial participation is not a valid choice. Thus, employee ownership will remain limited, as companies will be forced to stop using this particular form of financial participation.

Fairness to our Knowledge Workers

“In Silicon Valley -- where as many as one in four households have ESOs -- companies are cutting back on the number of options they share with workers. The Rutgers' researchers say that would be the wrong solution to the problem.” “It would be a sorry conclusion," Blasi said, "if the result of two years of horrible scandals in American corporations and an unprecedented public demand for corporate reform is that accountants persuade us to eliminate broad-based ownership for technology companies and other companies. ...” “*Stock Options Profits Benefited Workers, Study Shows*”, Schwanhausser, San Jose Mercury News, California, January 10, 2003

KLA-Tencor utilizes a broad based ESO plan that we firmly believe aligns our employees with our shareholders. To expense ESOs through the financial statement will surely force companies across the European Union to re-think their current use of broad-based ESOs and certainly stifle any new usage that may be in the works for start-up entities. This could create detrimental effects for both shareholders and knowledge workers around the globe. In the United States, we tried to address the real issues that stemmed from lax corporate governance practices through the implementation of Sarbanes-Oxley. ESOs were not the issue. Other countries, like China, are moving aggressively to encourage employee ownership and are recognizing the benefits of increased employee alignment with corporate goals. They will not make the mistake of stepping backwards by expensing ESOs.

Respectfully Submitted,

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