

ikon

From: Director - FASB
Sent: Friday, June 18, 2004 11:33 AM
To: ikon; Karen Salmansohn
Subject: FW: Comment Letter from Will Hearst, Kleiner Perkins Caufield and Byers

Letter of Comment No: 5123
File Reference: 1102-100

-----Original Message-----

From: Trae Vassallo [mailto:tvassallo@kpcb.com]
Sent: Friday, June 18, 2004 11:30 AM
To: Director - FASB
Cc: Trae Vassallo
Subject: FW: Comment Letter from Will Hearst, Kleiner Perkins Caufield and Byers

Please confirm that you received this comment letter that was sent on June 8th.
I haven't seen it posted yet and there are letters posted dated after this one.

Thanks-
Trae

From: Trae Vassallo
Sent: Tuesday, June 08, 2004 11:35 AM
To: director@fasb.org
Cc: Will Hearst; Jennifer Dowling; John Doerr; Trae Vassallo
Subject: Comment Letter from Will Hearst, Kleiner Perkins Caufield and Byers

File Reference: 1102-100

Dear FASB Directors:

I recommend that you consider some reform of your proposal on expensing of stock options. Rather than debate the semantics of what is the meaning of the word "compensation", allow me to offer four objections which, in the mind of this investor at least, cause the likely outcome of your current proposal to be harmful to companies and confusing to the investing public.

Expert practitioners

Accounting procedures should reflect the best practices of expert practitioners and make transparent the data needed by shareholders to make informed investment decisions. One could argue that disclosure of such data as recipients, amounts, strike prices, and terms of expiration and vesting of options (or other forms of incentive) are certainly necessary for rational investors to make their own calculations and subsequent decisions. To the extent such information is already a mandatory disclosure there is nothing missing.

In fact, in my observation, skilled investors in private companies, people who are managing money for endowments, foundations, pension funds and individuals take great care to account for the effect of stock options on their decision to invest and in computing the acceptable price at which they buy or sell ownership interest. However, they do not account for the effect of stock options in the manner proposed by FASB. Almost without exception such expert practitioners view the options as a contingent claim on equity which has the effect of diluting other shareholders' ownership, changing the economics of what a single share owns of the total enterprise and its consequent worth.

I have never encountered private equity investors who attempt to include a computation of the Black-Scholes, or Binomial, value in the companies P&L. Clearly such investors are keenly interested in the performance of the company's basic business. They simply do not believe that an "option expense" is a meaningful number. They do

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believe that the “dilution effect” is the correct way to measure those material effects.

Said another way, the EPS, the earnings attached to a single share does change – because the number of shares has changed.

Double counting

This is the second flaw in the FASB proposal. The effect of option grants will continue to be included in the computation of fully diluted shares, as it should be. But the new Option Expense charge will also be included in the EPS calculation – thereby counting the effect of options twice -- once in the numerator and again in the denominator. One is tempted to conclude from this double jeopardy, (and the proponents casual acceptance of it), that the agenda behind the so-called reform, is to harshly penalize the granting of options and thereby persuade owners to avoid granting them. Like reforms in the tax code, what you incent is what you get.

Rank and file impacts

Thus my third objection to the FASB expensing is its inevitable consequence: companies will switch away from option grants, especially for rank and file employees. Experts of various kinds may convince themselves otherwise, but the discussion already going on in board rooms across the country envisions curtailing the range of employees who will be included in stock option programs. Since a substantial percentage of the number of options granted by many high tech firms is awarded below the VP level this is the simplest way to cut down the number of option grants – as the new ruling wishes to encourage. Senior executives and key engineering talent may be the only people one can afford to retain with options if they are expensed under the FASB rules. Competition is the rule in business and few companies regard all their talent as equally valuable to their success.

That’s a shame since options granted to employees aligns their interest with investors and makes everybody pull for the same goals. The sharing of risk and reward on the same terms has reduced the tension between managers, owners and employees. For every great success in Silicon Valley there are typically new wealthy workers – whose personal outcome is vastly greater than what any reasonable salary would have produced.

They took the chance, they enjoy the reward too.

It also seems logical that in new businesses, based around risky and unproven technologies, which fail more often than they succeed, that only a possible big payday will offset the attractions of a more predictable career path and so draw the talent and capital to these less stable enterprises -- which are the vital seed corn of our economy.

To compel young companies to compete for experienced talent by paying out the rarest of their commodities – cash – seems like a formula engineered by establishment firms to curtail innovation and upstart enterprises. It will certainly have the effect of discouraging entrepreneurs to take the greater risks necessary to start new companies and perfect possibly disruptive technologies.

Perhaps that’s a valid public policy – one with which I would disagree. More likely, it is merely an unintended consequence of a bad idea. It’s no accident that the loudest voices in favor of expensing are all coming from the world of giant companies in slower growing sectors.

The Binomial Method

My last objection is that valuation methods proposed by FASB are subject to an unusually large number of free parameters – many of which are estimates made by managers and consultants with no independent verifiability.

To most analysts the Black-Scholes method is a poor estimator, except in rare cases which are quite distinct from employee stock option plans. FASB has proposed as a preferable alternative the Binomial method since it can be tweaked to simulate many of the features of real option plans such as, for example, time based vesting, cliff vesting,

accelerated vesting in the event of change of control transactions, possible forfeiture in case of termination or resignation, American call features, company dividends, variable volatility to name a few. But the greater range of the method also calls for a larger number of parameters. In fact different computations with the same parameters may differ depending on how the number of steps and time periods are selected.

More worrying is the freedom for management to make choices or offer estimates which vary from company to company even within the same industry. The opportunity to "get the number you want" is an almost inevitable temptation. How the new option expense line item will bring any accountability, clarity or consistency is beyond my imagining.

The real issue is that some people don't like options. They don't grant them at their company and they don't want you to grant them at yours either. If they can get FASB to make options unrealistically expensive, even at the cost of obscuring Income Statements, then new companies will have to conform to their old habits and play on their field.

Wise investors may see through the veil of smoke and concentrate their valuation energies on the company's ability to generate free cash, grow, and build franchise value. They will ignore option expense and look at the underlying business.

Others will drink the cool aid of option-expense EPS and happily compare apples and oranges, believing the new rules capture the essence of costs.

My suggestion is to modify the proposal so investors are not served up a lemon.

Sincerely,

William R. Hearst, III

Partner, Kleiner Perkins Caufield & Byers
Director, Hearst Corporation
Director, Hearst-Argyle Television
President, Hearst Foundation
Director, Juniper Networks