

ikon

Letter of Comment No: 5024
File Reference: 1102-100

From: Azem, Angela [aazem@accel.com]
Sent: Friday, June 18, 2004 1:23 PM
To: Director - FASB
Cc: jcdowling@nvca.org
Subject: File Reference No. 1102-100; comments from J. Peter Wagner

To: FASB Directors

cc: Jennifer Connell Dowling, NVCA

Reference: File Reference No. 1102-100

Comments of J. Peter Wagner the FASB Exposure Draft entitled *Share-Based Payment, and Amendment of FASB Statements No. 123 and 95.*

I am a Partner at Accel Partners, a venture capital firm in Palo Alto, California. Our firm manages over \$3 billion in capital and has invested in more than 200 early stage companies in emerging markets during our 20 year history. I have worked in networking and computing since the mid-1980's, as a physicist, line manager and venture investor. At Accel I focus on networked infrastructure, including the communications, computing, storage, and wireless sectors. Since joining Accel in 1996, I have led investments in 31 early stage companies, 5 of which have gone on to complete IPO's and 11 of which have been successfully acquired. I currently serve on the Board of Directors at several early stage companies. I am a Director of the Western Association of Venture Capitalists. I hold an A.B. in Physics from Harvard College, summa cum laude, and an M.B.A. from Harvard Business School, where I was a Baker Scholar.

As a venture investor I am intimately familiar with the fragile development of early stage technology companies. These companies have the propensity to stimulate the economy and build on the country's foundation of entrepreneurship and the American dream. They are oftentimes started on a shoestring, but have the ability to grown into backbones for the advancement of technology and medical research in the world. I am deeply troubled by the proposal regarding the expensing of stock options, as I fear the results will have a dramatic impact on these fragile companies. My reasons for opposition are both from a technical financial statement impact and also from an economic impact.

When asked whether or not stock options should be accounted for as a compensation expense, I consistently answer with a resounding, "No!" Options are not a compensation expense and as such they do not create a liability or represent real dollars for the company to spend. If they represent an opportunity cost, why is this the only opportunity cost that FASB requires to be recognized on financial statements? Has the FASB considered the quantification of the real dollars, that these companies do not have, required via compensation expense for hiring the experts to do the proposed valuations, not to mention the increased audit fees required to opine on these estimated opportunity costs? The real dollar costs of this "full employment act" for valuation experts and accountants could be enough to push a fragile innovative company over the edge or prevent one from starting. If the net income impact of the option expense coupled with the implementation expenses are not sufficient to impair company growth and viability, then clearly the other side of the ledger entry may be. The corresponding entry to the debit of the option expense is to credit a fictitious paid-in-capital that will not be delineated from real PIC that may cause problems for companies that have loan covenants or other legal obligations tied to PIC.

As I examine the proposed valuation methodologies for the expense estimate I am confused. If the option expense should be based on fair value, which is defined as a "willing buyer, willing seller" why is it that the bankers I have talked to have no interest in buying these employee options? Why is it that there is not an "employee option" market?

Is there no market for these options because their current restrictions do not yield willing buyers? If FASB encourages the use of the binomial modeling, vs. the current footnote disclosure using Black-Scholes, these companies will be forced to use, and justify to their auditors, more estimates. Under the current standard, FAS 123, FASB acknowledged that private companies could not accurately estimate stock volatility and allowed that input under Black-Scholes to be set at zero. Under the exposure draft, FASB explicitly prohibits minimum value, forcing companies to estimate stock volatility even if their stock does not trade. In addition FASB claimed that allowing private companies to use a modified intrinsic value method would be simpler and less costly, yet how can that be if the intrinsic value method requires companies to re-measure the price of the underlying common stock every reporting period? And how will these companies estimate early exercise behavior? Has someone substantiated the likelihood of a private company to exhibit early exercise behavior? I would think, given my knowledge of the industry, that any exercise behavior would only happen post-IPO. At the end of the day, any of the proposed valuation options lead to wildly varying valuations that only add to my confusion, and ultimately to the confusion of the financial statement reader. Why not blindfold our private company CFOs and ask them to hit the dartboard of proposed estimates, would that not yield similar results and be less expensive?

Aside from the reasons of onerous estimations, cost, and accounting for imploring FASB to reconsider the mandate to expense employee options, I would also ask that FASB contemplate how the expensing of options could impact the average American citizen, who is the ultimate beneficiary of these options. These start up companies represent the heart of our country that pumps the lifeblood of innovation and feeds the American dream. These innovations have, and should continue to impact, people around the world via technical or medical breakthroughs. However, these companies typically operate on very small budgets. Their ability to pay salaries that can compete with the larger established businesses is at best limited, and options are their best chance to attract and recruit top talent. If they stop issuing options, like some well-known public companies have already started to do, it has the potential to trickle down and crush innovation. If this happens, it would be the first time, to my knowledge, that an accounting pronouncement has the potential to stomp on our fragile innovative community.

Please reconsider this amendment, if not for all companies, then at least for private companies, and give the innovative leaders in this country a fighting chance to further the American dream.

Sincerely,

J. Peter Wagner

Accel Partners