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From: Allan Ferguson [Allan_Ferguson@3i.com]
Sent: Thursday, June 24, 2004 12:26 PM
To: Director - FASB
Cc: jcdowling@nvca.org
Subject: Reference File No. 1102-100

In response to the Financial Accounting Standards Board's Invitation to Comment on accounting for employee stock options, I am writing to you as the Managing Director of 3i Technology Corporation., a private equity investor, to express strong opposition to the proposal as currently drafted. I am concerned that the proposed expensing of stock options *FASB File Reference No. 1102-100* is bad for The United States and will make the US less competitive globally. Expensing stock options would add confusion instead of clarity to financial standards in an attempt to thwart a very small minority who has committed fraud. This approach to stopping this fraud, by the method proposed, will end up punishing our economy and global competitiveness. It is the financial standards equivalent of "friendly fire" - and in all likelihood will bring us into the land of unintended consequences.

As an investor in development-stage technology companies, we oppose the expensing of stock options for several reasons. However, we feel it would be beneficial to articulate, as context to our opposition, our understanding of FASB's objectives with respect to expensing options. Fundamentally, any change to an accounting treatment and the subsequent presentation of financial statements must endeavor to improve the accuracy and transparency of the financial statements and ensure that they accurately portray a company's financial position. Such a change should provide the reader (e.g., equity investors, creditors, regulators and the public) with relevant, reliable and useful information that they can use in making sound business or investment decisions. FASB has commented that expensing options will do just that; give the readers a more accurate portrayal of a company's financial position. It has also been proposed that expensing options will combat corporate malfeasance and prevent scandals such as those that occurred at Enron and WorldCom.

I feel strongly that neither of the stated objectives will be achieved by expensing options. Rather, expensing options will only obfuscate financial statements and impede our ability to attract and retain employees to our portfolio companies. Stock options are equity transactions, not an expense, and therefore should be reflected in the dilutive effect on ownership in the capitalization table as well as on the balance sheet. It should not be reflected on the P&L statement.

Expensing option grants does not provide a more accurate view of a company's financial statements.

The purpose of the statement of operations is to summarize a company's earnings or losses by matching the revenues earned from sales of products or services against the expenses necessary to generate these sales. Option expense is not appropriate in this context given that options require no cash outlay and do not accurately reflect the cost of operation. Further, even if options were to be included in the statement of operations, there is no remotely effective method for valuing these options. Models such as Black-Scholes or the binomial method are wholly inaccurate indicators of value. Finally, under FASB's current proposal, there is no way to credit a company for options that are never exercised either because the employee is terminated or stock is below the option's strike price. In conclusion, putting an inappropriate value of a non-cash expense in the statement of operations devalues it as a viable tool for investors to use in evaluating a company's financial position, which is the opposite of the benefit that you are trying to achieve.

In my opinion, the use of the "fair value" methodology for calculating the compensation cost for stock options creates less, not more clarity and transparency to a company's financial reports. Given the degree of subjectivity associated with several of the "fair value" calculation inputs (i.e. volatility, employee behavior...); the results are far less comparable across time for a given company or across companies at a given time. In addition, given that many investors are interested in the after-tax cash flows in the process of valuing companies, the proposed reporting

6/24/2004

requirements make that job harder, not easier for those investors.

Specifically with respect to private companies, their investors and creditors pay minimal attention to earnings per share performance. Their collective focus is on cash – cash balance, cash generation, cash consumption and the cash required for the company to reach self-sufficiency. Consequently, it is hard to understand how the expensing of stock options will provide any value to the capital and resource allocation decision processes of the private companies, its investors or creditors. In fact, the reporting requirements will only make the financial statements less helpful in assessing company performance since it will be more difficult to model cash.

Expensing option grants will not prevent corporate malfeasance.

The accounting scandal at Enron would not have been prevented or foreseen by requiring options to be expensed. Technically, Enron's ability to commit fraud had to do with its balance sheet and certain nonsensical rules that allowed it to transfer assets and liabilities to special purpose entities. If we want to prevent similar behavior there are much more effective approaches than debating whether stock options are expensed or not. Ultimately, only ethical management, sensible governance, adequate internal control systems and comprehensive disclosure will prevent another one of these disasters.

Options grants are a key tool in recruitment.

Options are a key method of compensation that help development stage companies recruit, retain and motivate high quality employees. Growing, entrepreneurial enterprises need options as a tool to bring new innovations to market because they allow us to compete for and lure away top talent. Forcing us to expense options will make us re-evaluate issuing options given the steep penalties we will now have to pay. Without options we are at a significant competitive disadvantage to larger companies who can afford richer compensation packages than entrepreneurial startups. These larger companies, where the fraud has taken place, have not been the creators of jobs in the past several decades.

Reduced competitiveness

As indicated earlier, it is my understanding that many of the companies in China and India, who now or will in the future compete with our portfolio companies, do not have to deal with the confusion and cost associated with expensing stock options. This will give those companies a decided advantage as our portfolio companies compete in an ever more global marketplace, especially when it comes to recruiting and retaining the best entrepreneurial talent.

Small, high-growth, entrepreneurial companies represent our country's most promising source of economic fuel. These companies create the vast majority of new jobs, generate revenues that contribute significantly to the GDP, and foster groundbreaking technology used throughout the world. As discussed earlier, these development stage companies are fuelled by stock options which, unlike large companies, are given to all employees. While only 3% of small companies are venture backed, these are the companies that have created the jobs and driven the U.S. economy and are the companies who distribute options broadly throughout the employee base.

We have an urgent concern that the Financial Accounting Standards Board (FASB) could change all of that if it mandates the expensing of stock options. This is especially troublesome because the academic models for valuing options were designed for much larger companies with more stable valuations and are inappropriate for high-risk, venture-backed firms. The promise of ownership (realized via stock options) has enabled us to compete for the talent necessary to build our companies, despite scarce cash resources.

In conclusion, while we support many of the recent initiatives to clarify and better regulate financial reporting, we categorically oppose the expensing of options. Not only do we not see any benefit to this proposal, if implemented the expensing of stock options will increase significantly administrative and compliance costs; for a development stage

Reference File No. 1102-100

company this is devastating. More importantly, it will not provide the clarity or insight that you suggest you are trying to achieve for investors. I sincerely hope that this feedback is helpful and we would be pleased to provide further information regarding the contents of this letter.

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