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Financial Accounting Standards Board
401 Merritt 7
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Letter of Comment No: 4398
File Reference: 1102-100

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Dear Director:

I write in opposition to the proposal to treat stock options as a compensation expense. I believe this is the wrong accounting treatment. Moreover, this incorrect accounting will hurt small business, particularly those who rely on stock options to motivate employees. In our own case, being unable to use options as an effective compensation tool would likely have destroyed our company

Background:

I am CEO of OpenAir, a private technology company in Boston, MA. Although our business could not be more different from those of the original patriots, we share a common belief in the power of markets and fair rules as the cornerstone of a healthy American republic.

Our company, founded in 1999, overcame the struggles of the dot.com crash to become profitable in late 2003 and begin creating new jobs in 2004.

We have hundreds of customers who rely on us, and we are proud of our work.

Our employees typically work for cash compensation that is below what they could earn at larger companies. Every single one of our employees, however, has options to purchase stock in our company. We are motivated by the hope that one day we will increase the value of our company enough so that our ownership share will more than compensate us for our forgoing current cash compensation. It is the classic entrepreneur's bet.

The role of options:

Stock options allow our company to motivate employees by giving them a stake in the company. In the old days, unless you owned the company, you were basically a worker, and the success of the company was reflected in the fact that you kept your job. Now, through the widespread use of options, we try to push employees to feel like owners and act the way owners act.

The cost of options:

All of our investors recognize that options represent a cost to them. Our investors understand that they are giving up part of their ownership interest in the company to the employees.

What this means is that if we are fortunate enough to deliver a return to the investors they will get a lower payback than they would have received because a portion of the value will go to the employees.

This is what is meant by dilution. Because our employees hold options and similar rights to purchase a portion of our company, our investors will receive less than the undiluted – that is, not taking into account the options – interest they hold in the company.

Why this trade is worth it:

Our investors are happy to make this trade because it comes with two enormous benefits. First, we all work harder because we act like owners. Second, we are able to build our business using less cash. We attract and retain talented people with options, rather than cash bonuses. Our investors are able to fund more businesses using the cash they have. Our business is very high risk so the benefit of using less cash is even greater. Without this flexibility, we would have run out of money before we became profitable, and our business would have died.

Why are options not an expense:

Options represent a dilution of the ownership interest in the company. I fully agree that they should be reflected on the balance sheet. For example, let's assume that a company has 10 million shares outstanding and 2 million shares under option to the employees. If that company is sold for \$10 million, the investors will not realize a \$1 per share. Assuming that all the options are exercised, the investors would receive less. Specifically, they would receive 10/12ths of \$1 or roughly 83 cents. What happened to the other 17 cents? It was the employee share of the proceeds of the sale of the company.

None of these items have touched the income statement, which is where expenses are properly reflected. They are all balance sheet items and should be reflected as such.

Many accomplished financiers disagree. Here is the argument: A company is compensating – in plain English, paying – its employees with options. Compensation – again in plain English, salary – is the most basic type of expense. Therefore, since options are salary at some level, you should estimate how much these options are worth and include them in the income statement.

As I have shown above, that argument does not reflect the economic reality of the way that options provide incentives for our employees. Options are not salary; instead, they are an investment – often a risky investment – in the company. Options are thus no different from any other investment in a company. In our terms, it is called “sweat equity” as opposed to the traditional cash equity.

What happens if you expense options:

If we were forced to expense options, two things would happen. First, it would distort our income statement. We would have to run two sets of books, creating a pro forma set of financial statements that excluded the options, in order to understand the true financial health of our

business. Second, this proposal will create a burden on us. Valuing options is a complex exercise and an inexact science. I will pay an expert to do something that is completely useless for both the managers and investors in a business. My investors don't care how much outstanding options are worth. They only care about the value of the business (largely derived from our revenue and earnings) and what share they own of it. If I went to my investors and said that I would like options for 50% of the company, we wouldn't be having a discussion about the value of the options; my investors would object on the grounds that my "sweat equity" i.e. my investment, was not worth that much.

Business is hard:

Sometimes I feel that there is a lack of appreciation for how hard it is to build a business and to create value. It takes years and is fraught with risk. Financial accounting rules that make it unnecessarily expensive for companies to attract investment – including investment by employees – will suppress business development, reduce economic growth, and destroy jobs. It is that simple.

I support full and accurate financial disclosure. It is a point of pride and obligation for our company that we report accurate numbers.

The reason I am against expensing options is because it does not promote full and fair disclosure and it makes it harder for us to build our business. Indeed, being unable to use options as an effective compensation tool would likely have destroyed our company.

Sincerely,



Morris Panner

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