cardinal partners

June 30, 2004

Letter of Comment No: 5820
File Reference: 1102-100

Director
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Share-Based Payment—an amendment of Statements No. 123 and 95
File Reference No. 1102-100

To Whom it May Concern:

I have been active member of the venture capital community for over 20 years. I am the Managing Partner of Cardinal Partners, an early stage venture capital firm in Princeton, New Jersey. Over the course of my venture capital career, I have founded or co-founded over 20 companies, creating thousands of jobs. Many of these companies are in the emerging Biotechnology industry, developing new technologies that improve the quality of life for millions of people worldwide.

Numerous experts have weighed in on the topic of whether expensing of stock options is appropriate. My view is that stock options are not a cost of doing business, do not affect revenue or operations, do not create a liability or out of pocket cost to the company and consequently should not be factored into the profit and loss of an enterprise. Stock options reflect a movement in the ownership capital of a company and should not be shown as an expense in financial statements, or even in a "pro-forma disclosure note.

There is also a considerable cost imposed by the proposed new rules in the form of (i) potential inaccuracies in financial reporting resulting from unreliable option valuation methodologies and (ii) substantial expense to prepare the new financial reports in the form of fees payable to accounting and valuation firms. These costs are an area of particular concern to private start-up companies who are in less of a position to absorb the costs and whose shares are very difficult to value using the proposed valuation methods.

The Exposure Draft guidelines call for the use of the Black-Scholes or the binomial valuation methodology. Both of these are complex formulations that have a tendency to create inconsistent results when applied across different companies in different industries over time. The problems are compounded when these formulas are applied to a private company that does not have freely tradable stock or readily available means to evaluate

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critical variables in the formulas such as stock volatility. The inconsistency of these estimates, especially when applied to private companies, creates confusion rather than clarity in financial statements.

In an effort to address the concerns expressed in the preceding paragraph, the FASB has proposed the use of the "intrinsic value" method when it is not possible to estimate fair value. This methodology does not solve the problem. Using the intrinsic value method a company would need to re-estimate its fair value each reporting period, resulting in inconsistency and compounding the use of unreliable estimates.

As a result, a reasonable company exercising an appropriate amount of diligence and care when generating the estimates used in the formulas described above would necessarily engage accountants, valuation firms and other experts to ensure that their estimates are in line with best industry practices and in compliance with the new rules. Although transparency is important, the time and expense required to prepare these unreliable and inconsistent disclosures outweighs the marginal benefits afforded by the disclosures that are the goal of the proposed new accounting rules.

Finally, in my view one of the most critical elements in the model for success of the companies I have founded has been a broad-based stock option plan that delivers equity value to the broadest possible class of employee within the organization. The new accounting rules outlined in the Exposure Draft create disincentives to start-ups that want to utilize employee stock options as a part of their business model. In a highly competitive environment, the lack of substantial financial resources faced my many emerging companies leads them to use employee stock options as a major element in attracting and incentivizing talented employees. Eliminating or reducing the use of employee stock options would do a great deal of damage to this business model that has been so successful over the last 20 years. If the FASB decides to implement some form of the proposed option expense regulations, then at a minimum it should consider providing an exemption form the new rules to private companies and to any broad based employee option pool.

Sincerely,

CARDINAL PARTNERS

John K. Clarke
Managing General Partner

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