Letter of Comment No: 3265

## ikon

Director - FASB From:

File Reference: 1102-100

Monday, June 07, 2004 4:36 PM Sent:

To: ikon; Karen Salmansohn

Subject: FW: Feedback: Share-Based Payment, and Amendment of FASB Statements No. 123 and 95

----Original Message----

**From:** Mark Tapling [mailto:Mark.Tapling@everypath.com]

**Sent:** Monday, June 07, 2004 4:37 PM

To: Director - FASB

Cc: 'jcdowling@nvca.org'; Dave Shrigley (E-mail)

Subject: Feedback: Share-Based Payment, and Amendment of FASB Statements No. 123 and 95

Dear Sir or Madam:

As the CEO of a private venture backed company, I feel compelled to weigh in on the disastrous effect pending legislation regarding the expensing of stock options will have on private companies. The essence of my strong disagreement is that the currently proposed solution widely misses the intended target, does not meet the needs of its intended audience, and does significant harm to private companies.

Current legislation for the expensing of stock compensation in public companies is a source of ongoing debate. While that system is not perfect, it does provide a level of transparency for the public shareholder. In combination with new reporting regulations introduced by Sarbanes-Oxley, the government has more than successfully added an unprecedented level of transparency and regulatory expense to financial reporting in public companies. The concept of taking a less than perfect valuation and expense model and then attempting to apply it to private companies is not a workable solution under any circumstances.

Please consider the following differences and situations.

In an initial public offering situation, all of the preferred shares are converted to common before the offering. In addition, based on the size and price of the offering, any valuation discrepancies are expensed and audited by the SEC. At this point in a company's life, the only investors affected are those early investors who had board seats and preferred stock. Experienced investors who participated in a fair market auction for price and terms. Employees who may have enjoyed a favorable valuation in a non-liquid equity asset, are reconciled to fair market valuation under the oversight of the SEC. This system works, there is no need for change.

Small venture backed companies operate at planned losses during their early lives. Valuations are set by venture investors who comprise a market of willing buyers, setting a market price. Founders and management of the private companies accepting venture investment willingly accept a "term sheet" with a defined price and associated terms. This type of interaction represents market capitalism in its purest form. Ultimately, since the price is set in a free market auction, the price of privately traded shares represent the most accurate valuation of the company; a willing buyer and a willing seller.

The most important variable in the valuation of a small, privately held, venture backed company is it's operating performance. Diluting the pure operating numbers with accounting oriented expenses, provide a veiled view of the company's operating success, and make it more difficult for the average investor to gain visibility as a potential acquirer. A system that would have private companies reporting financials without expensing stock options for employees, and also creating a Quarterly pro-forma that includes stock option expenses, enables investors to evaluate a small company against both private and public metrics. If needed, this view could become a component of the S1 filing documents.

Many employees leave small companies before the stock ever becomes liquid, and in many cases even is vested. As a result, the fairest means for calculating valuations of incentive stock options would be a mathematical model that includes sector comparables for the company, using the vesting date as the anniversary date. Stock that is not vested is returned to the company, and hence never offers any value to the assignee, or dilution for investors.

In the interest of maintaining the cleanest appropriate accounting for employee ownership, private companies work extremely hard to avoid any inconsistencies in the handling the terms of employees stock option ownership. Examples include setting the price,

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re-pricing options or replacing options, frivolous vesting terms, or any special consideration regarding the ability to pledge, transfer ownership, or trade shares of stock. As a result, proposed valuation methods like "intrinsic value", fundamentally work against investor transparency, by plunging the company into variable accounting. The result is a complex and error prone stock option valuation calculation that opens a new window for miscalculation of the actual expense of outstanding employee stock options.

The concept of expensing stock options on a per grant/per employee basis is unworkable. This initiative confuses the rights of investors, with the responsibility of management and the board of directors. As an accounting issue, it is more important to have a consistent, easily understood method for valuing stock options, than a complex, labor intensive table that tries to track every grant in a company's history. For the investor, the total compensation expense for stock options is an important issue, but employee compensation and motivation strategies are the work of management and the board. Needlessly handicapping small companies with a complex accounting burden that provides data that is best classified as "interesting" to investors, is not to anyone's benefit. Further, the S1 requires the compensation of the 5 most highly paid staff in the company be disclosed, and broken down by compensation type.

In summary, I agree that transparency in the cost of stock options to investors is an important issue. I strongly disagree, that the system is broken for private companies, or that the transition accounting required for an initial public offering is ineffective. I strongly encourage extended research into these issues before pre-maturely pulling the trigger on a policy that will have the same effect as the firing squad on small companies.

Thank you for your careful consideration.

Sincerely,

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