Letter of Comment No: 5533

File Reference: 1102-100

ikon

From: Bob Grady [Robert.Grady@carlyle.com]

Sent: Wednesday, June 30, 2004 2:50 PM

Director - FASB To:

Subject: File Reference Number 1102-100

Dear Mr. Herz:

I am writing in response to the Financial Standards Accounting Board's ("FASB's") exposure draft regarding Share-Based Payment, which includes the FASB's proposal to require the mandatory expensing of incentive-based stock options for both public and privately-held companies.

In summary, the FASB's proposal to require expensing is inappropriate, incorrect as a matter of either financial or accounting theory, poorly thought-out, and unworkable.

It is important in finalizing this proposal to consider the typical real world use of stock options in our economy today. I work in a venture capital firm. Venture capitalists provide risk capital to job-creating companies, most of which do not have the resources or the history to borrow from banks or other debt providers or the size to raise capital in the public equity markets. The one thing they do have is the ability to create jobs as they seek to turn the innovative ideas of today into the big companies of tomorrow.

The two funds I directly manage, Carlyle Venture Partners I and II, established in 1997 and 2002 respectively, continue to have investments in 38 startup companies that today employ over 4,000 people. In the companies on whose board I sit – Blackboard in Washington, DC; Panasas in Fremont, California; USBX in Los Angeles; Secure Elements in Herndon, Virginia; Authentec in Melbourne, Florida; and Ingenio, in San Francisco, California - incentive stock options are granted to every employee, from the receptionist to the CEO.

This is typical in the venture capital world. According to a recent survey by our association, the National Venture Capital Association, in over 70% of venture-backed companies, stock options were awarded to ALL employees.

The standard type of grant in venture-backed companies is a grant that is vested to encourage the employee to continue to work at the company over time. A very typical structure, that commonly in use most venture-backed companies today, calls for an option grant to vest over four years - with so-called "cliff vesting" of one quarter of the options granted vesting on the first anniversary of the grant, and then monthly vesting of the remaining three quarters of the grant on a straight-line basis over the next three years. This is important, because under the FASB's Exposure Draft, the normal grant of stock options, the one used by virtually every venture-backed company in America, would have to be valued 37 different times - per grant! In my view, this would not make financial statements more understandable.

I would like to comment specifically on the Exposure Draft. I feel compelled to start with a fundamental conceptual point. Options are shares, or units of ownership. They are not claims of cash, or uses of the company's assets. They should be treated and disclosed as such: in the denominator, if you will, of the Earnings Per Share (EPS) calculation. If the FASB were proposing in this Exposure Draft that when companies report earnings per share, they be required to use a fully diluted share count, including all options outstanding, in the denominator, I believe that would be a fair and conceptually correct proposal.

This point is essential. At its heart, what this debate is all about is that many Americans (and people all over the world, for that matter), are willing to trade off cash compensation in favor of ownership. They are willing to earn less cash today, and thereby create less in terms of ongoing expenses by the company, so that over the long-term they can make the company worth more, because they are owners — they are thinking like owners. And this is a good thing for all those who choose to join them as shareholders along the way — because their interests are aligned as mutual owners of the securities of the company.

Ironically, proponents of expensing say that requiring it will not have the dire effects on companies many predict because investors will merely strip out the effect of expensing to look at cash EPS. In other words, they will ignore GAAP, precisely because it will not be representative of the company's true expenses. So the irony of the FASB's proposal is that it is likely to undermine confidence in and use of GAAP – which one presumes to be the exact opposite of the intended effect.

Beyond this fundamental conceptual point, there are several additional obstacles which make implementation of the FASB's proposal on expensing unworkable.

The first obstacle is trying to define the appropriate measurement date at which to value the option. The FASB has suggested that the grant date is appropriate. The problem with this, of course, is that the value of the option at grant date is highly uncertain. It may never vest, because the employee may leave. It may never be exercised, because the stock may never be "in the money" in the appropriate time frame.

Moving the measurement date to exercise date presents other difficulties. This would simply penalize the most successful companies – or those with the brightest prospects – for the mere fact that their stock has appreciated, while rewarding with more "profits" those whose is language.

The second problem is the difficulty of trying to determine what an option is worth. For private company options, which have never traded, the value of options must be modeled – and the choice of model and of methodology leads to radically different assessments of value.

That of course leads directly to a third problem, which is that many of the models one could choose – including Black-Scholes, named the for the late Fisher Black and my former colleague from the Stanford Business School faculty Mryon Scholes, and virtually any binomial model – rely on one key variable, the estimate of the volatility of the underlying stock. For private companies, since the stock has of course never traded, any estimate of volatility will be a guess. It will be subject to manipulation and inaccuracy.

That leads to a fourth problem. Because of the impossibility of accurately estimating in advance the volatility of a security that doesn't trade, FASB's proposal would allow private companies to elect the use of the "intrinsic value" method for valuing options instead. Under this methodology, the value of the option is adjusted for each reporting period, depending on stock price. This form of variable accounting brings the stock price directly into the income statement and introduces the potential for wild swings from quarter to quarter in the value of the same option. It would be massively confusing.

A fifth problem which the FASB ignored is that most private company employee options are highly restricted. They are subject to

vesting and generally cannot be transferred, hedged, pledged or sold. It is hard to value these restrictions, so the FASB argues that no restrictions that exist during the vesting period should be considered in valuing options. Clearly an option subject to restrictions is worth less than an option not subject to restrictions, yet the FASB's proposal would have us record them at the same price. This is antithetical to the concept of fair value.

Finally, in seeking to identify the proper time period to which to attribute the expense that its Exposure Draft would require to be recorded, the FASB's proposal encounters a whole new set of problems. For example, the Exposure Draft suggests that companies should group their employees for purposes of predicting exercise behavior. This would be a completely speculative exercise that would be almost preposterous in its unreliability.

All of these obstacles, by introducing theory, uncertainty and subjectivity in the place of actual experience – which is what financial statements are supposed to reflect – will make the income statements of companies less reliable, not more reliable.

I believe that the FASB's proposal is that it is responsive – not to the voluminous comment that has been provided by experts and actual companies, not to the obvious problems that have been pointed out with mandatory expensing, especially for private companies, but to the political process. This appears to be an entirely political proposal.

It seems the FASB feels it must respond in a political fashion to the news reports of senior executives at companies like Tyco, Worldcom, or Adelphia looting their companies and overseeing the preparation of false accounting statements. I believe that there should be a strong response to these atrocities – if found guilty, the individuals responsible should go to jail. But these examples of personal greed have nothing to do with the fact that at many young companies the broad base of employees have been willing to take ownership and not cash in enterprises they think can grow. These scandals have nothing to do with the issue of expensing broad-based employee stock option grants.

Thank you for the opportunity to comment. I strongly oppose the FASB's ill-considered proposal.

Sincerely,

Robert E. Grady
Managing Director
The Carlyle Group
600 Montgomery Street
39th Floor
San Francisco, California 94111
Tel: 415-678-3549

Fax: 415-678-3510

Email: bob.grady@carlyle.com

- CONFIDENTIALITY NOTICE -

The information contained in this transmission is intended only for the person or entity to which it is addressed and