

Letter of Comment No: 5493
File Reference: 1102-100



National Venture Capital Association

June 29, 2004

VIA E-MAIL AND U.S. MAIL

Ms. Suzanne Bielstein
Director of Major Projects – File Reference 1102-100
Financial Accounting Standards Board 401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Re: Proposed Statement of Financial Accounting Standards
Share-Based Payment, an amendment of FASB Statements No. 123 and 95

Dear Ms. Bielstein:

On behalf of the National Venture Capital Association (“NVCA”), I am writing to offer comments on the *Proposed Statement of Financial Accounting Standards, Share-Based Payment, an amendment of FASB Statements No. 123 and 95*, dated March 31, 2003 (the “Exposure Draft”). The NVCA has been actively involved in the stock option debate from the beginning and we appreciate the opportunity to express our views to the Board.

The NVCA represents over 450 venture capital firms in the United States. These firms are currently invested in over 5000 portfolio companies. U.S. companies originally funded with venture capital now represent 11% of annual GDP and employ over 10 million Americans.

Overview

As you know from our previous discussions and presentations we are very disappointed with the Board’s conclusions in the Exposure Draft and believe that the recommended changes will be wholly unworkable for private, newly-public, and small companies. In our opinion the

Exposure Draft recommends changes that run counter to the fundamental mission of the Board: “to establish and improve standards of financial accounting and reporting for the guidance and education of the public, auditors, and users of financial information. In fulfilling its mission, the Board is “[t]o promulgate standards only when the expected benefits exceed the perceived costs.¹ Our conclusion, after speaking with our member firms and many of their portfolio companies across the country, is that implementation of the Exposure Draft would not “improve standards of financial accounting and reporting” for any company, public or private, and for private, newly public, and small companies, the costs would far outweigh any perceived benefits. We understand the Board’s desire to have a single standard applicable to all companies, large and small, public and private. However, unless that standard was readily understandable by the specific users of the financial statements, was easily implemented and auditable, and the costs of implementation and compliance were low, then we conclude that the Board has not successfully fulfilled its mission. We believe that private, newly public, and small companies will be unfairly and disproportionately penalized, and materially damaged by the rules outlined in the Exposure Draft if they use stock options.

Based on numerous discussions with valuation professionals and audit firms, we estimate that the annual cost to a typical venture-backed company of implementing either the “fair value” or the variable intrinsic value method set forth in the Exposure Draft will range from \$30,000 - \$100,000 in increased external consultant and auditor costs alone. To the extent companies do not have sufficient internal staffing, as most do not, these cost would be even greater. This level

¹ FASB Facts, www.fasb.org/facts/index.shtml

of cost is a huge burden for the portfolio companies in which our members invest and, for this reason, as well as the others we discuss in detail below, we believe that both valuation methods are inappropriate.

Following our comments on the specific issues raised in the Exposure Draft, we offer an outline of a proposed standard for private, newly-public, and small businesses. We believe that our proposal would fulfill the Board's mission and we would be pleased to discuss our proposal in greater length with the Board at its convenience.

Issue 1: Do you agree with the Board's conclusion that employee stock options give rise to recognizable compensation costs?

We do not believe that the granting of employee stock options gives rise to recognizable compensation cost. Expenses are defined under Statement of Financial Accounting Concepts No. 6 as an "outflow[] or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing good, rendering service, or carrying out other activities that constitute the entity's ongoing major or central operations." ¶80. When employee stock options are granted, there is no outflow or using up of existing corporate assets. Moreover, there is no corporate liability created when options are granted. All that occurs is that an employee is given the right, if and only if they comply with certain conditions, to purchase a share of stock at a predetermined price at some later date. Thus, unlike restricted stock, an employee stock option is not a cash equivalent.

Moreover, the NVCA disagrees with the Exposure Draft's basic premise that employee stock options are, in fact, a form of "compensation." In general, the NVCA agrees that stock options can be compensation where there is an explicit exchange of options for cash or other

direct forms of payment. But that is seldom the case in the context of employee stock options. Most grants are unilateral, and not explicit exchanges of value. In the venture capital world, many employers grant options to all employees and there is no bargaining. In the absence of options, few venture-backed companies would pay the majority of their option recipients more cash compensation. Thus, employees are not receiving compensation. Instead, they are receiving a unique form of capital available only to employees that may or may not ultimately impact the outstanding equity of the corporation.

Issue 2: Do you agree with the Board's conclusion that pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements?

As stated above, the NVCA continues to believe that recognition of a financial statement expense is not the appropriate treatment. That having been said, we recognize that some people disagree with our position. We also note that the Big 4 accounting firms have changed their position on this issue several times over the past 10 years even though there has been no change in financial principles or the guiding accounting concepts.

Given all of the problems with valuing stock options, which we discuss in detail below, and the lack of consensus as to whether the issuance of employee stock options meets the definition of an expense, the NVCA continues to believe that footnote disclosure is the most appropriate presentation. We also note that such treatment is consistent with the treatment afforded contingencies under FAS 5. For private, newly-public, and small companies, pro forma reporting of the Board's proposed standard would impose a tremendous cost burden. For this reason pro forma reporting would not be a viable alternative for such companies.

For more established public companies, pro forma reporting of the impact of stock option issuance would certainly be preferable to mandatory reporting in the financial statements. Some financial statement users believe that information regarding purported stock option expense is meaningful, but many others do not. Accordingly, the Board should satisfy all constituencies, not just those that agree with the Board's tentative conclusions as set forth in the Exposure Draft. Pro forma reporting would do just that. Those who believe the purported expense is a meaningful number will have pro forma financial statements that show the impact (and will not have to engage in any analysis based on footnote information). Similarly, those who do not believe that the purported expense is a meaningful number also will have financial statements that they will find immediately useable (and they will not have to perform any analysis to back out numbers that they believe are meaningless).

Issue 3: Do you agree that fair value is the relevant measurement attribute and that grant date is the appropriate measurement date for equity instruments issued by public companies?

As discussed above, the NVCA does not believe that the granting of employee stock options meets the accounting definition of an expense. However, if a mandatory expensing standard were required, we believe that intrinsic value at grant is the appropriate measure.

The valuation methods referenced by the Board are the same as in FAS 123 and, as a result, the reasoning espoused by a number of the then Big 6 at that time still holds true today.

For example, in response to the FAS 123 Exposure Draft, Coopers & Lybrand stated that:

There is no disagreement that stock options provide the employees with a benefit that is valuable. However, there is considerable disagreement as to whether any cost that might be associated with that benefit should be recorded in the financial statements and, if so, whether there is any reliable means of measurement. APB

Opinion No. 25 concluded that for fixed stock options, such cost is simply the options' intrinsic value at the grant date. We are not persuaded that a better and more reliable measure of the employer's cost is available at this time.²

Similarly, Ernst & Young concluded "although admittedly a simple approach, intrinsic value on the grant date provides a more reliable and comparable measurement than using option pricing models that were developed for purposes other than to value employee stock options, and whose values do not have general acceptance."³ KPMG Peat Marwick also agreed:

- The intrinsic measurement method that is used in APB Opinion No. 25 (APB No. 25) should be retained.
- Awards that call for settlement by issuing equity instruments are equity instruments and measurement of such awards should be made at grant date to the extent possible. Thus, the approach used in APB No. 25 for "fixed" plans should be continued. We also believe that compensation cost for awards under "variable" plans should be measured using the intrinsic approach at the grant date if the exercise price is set at that time (or if the exercise price increases over time). This change to APB No. 25 would significantly reduce the disincentive of providing "variable" plans since changes in the market price of the underlying stock would not impact compensation cost for plans where the variable feature is the number of awards earned.⁴

While we agree that fair value could potentially be an appropriate measurement attribute, and we agree that fair value should be defined using a willing buyer-willing seller standard, the provisions of the Exposure Draft, if adopted in their current form, in no way would result in a fair value measurement of employee stock options. Indeed,

² Letter dated December 29, 1993 from Cooper & Lybrand, at pp. 1-2.

³ Letter dated December 6, 1993 from Ernst & Young, at p. 7.

⁴ Letter dated December 28, 1993 from KPMG Peat Marwick, at p. 1.

Professor Mark Rubenstein, the developer of the Board's preferred valuation method, the binomial model, recently told the Board "Don't use it. It doesn't work."⁵

Issues 4(a), 4(b), and 4(c): Does the Exposure Draft provide sufficient guidance to "ensure that the fair value measurement objective is applied with reasonable consistency," do constituents agree with the conclusion that the fair value of options can be measured reliably with lattice models, and how should volatility be estimated?

As we stated in our November 4, 2002 letter to the Board in connection with its "Invitation to Comment," existing option-pricing models use complicated formulas based on numerous assumptions, including predictions of interest rates, dividend expectations, employee exercise behavior, and stock volatility up to 10 years into the future. The same model can produce widely divergent results depending upon what guesses a company uses. Professor Rubenstein's statement regarding the fact that his model will not accurately value employee stock options reinforces these conclusions. The Exposure Draft, like FAS 123, does not provide sufficient guidance to "ensure that the fair value measurement objective is applied with reasonable consistency." Indeed, the Exposure Draft provides no guidance on how companies should determine the inputs that they use in the models, let alone how auditors should audit those numbers.

Volatility

One of the most problematic features of option pricing models is the need for a volatility input. The Exposure Draft provides that companies should not look solely to historical volatility when determining this volatility input. Instead, companies are supposed to anticipate future

⁵ "Pinched battle on options/Federal regulators face off against tech companies at Palo Alto forum on expensing," The San Francisco Chronicle, June 25, 2004.

events up to 10 years in the future. This is difficult enough for public companies. But for private companies, the problems with the use of the fair value method are exacerbated because they would require these companies to determine the volatility of a stock that rarely trades. Newly-public and small companies with thinly traded stock face similar problems. No one knows how to reliably estimate the 10-year future volatility of such stocks and there is absolutely no guidance on this point provided in the Exposure Draft.

Under FAS 123, private companies are allowed to use what the Board has termed “minimum value.” We believe that the use of this method for estimating volatility should be maintained if companies were to use a fair value measure. Indeed, because of the significant issues that existed with the same option pricing models currently referenced in the Exposure Draft (Black-Scholes and binomial or lattice models), Deloitte & Touche told the Board when they were considering FAS 123 that “we support use of the minimum value method for all companies.”⁶ Although they stated that the use of minimum value “is not intended to produce an estimate of fair value, it can be relied on to produce a reasonable estimate of compensation cost. It is also simple to use and promotes comparability among enterprises, whether public or private.”⁷ The Board agreed in FAS 123 and determined that “estimating expected volatility for the stock of a newly formed entity that is rarely traded, even privately, is not feasible.”⁸

Recently, the Technical Issues Committee (“TIC”) of the American Institute of Certified Public Accountants commented on this Exposure Draft that it:

⁶ Letter dated November 5, 1993 from Deloitte & Touche, at p. 3.

⁷ Deloitte & Touche Letter at p. 5-6.

⁸ FAS 123 at ¶ 174.

continues to believe that the board should retain the minimum value method (MVM) described in SFAS No. 123, *Accounting for Stock-Based Compensation*, as the alternative valuation method for nonpublic entities. . . . The MVM is at least as conceptually sound as the [variable intrinsic value method proposed in the Exposure Draft] and has the added advantages of being consistent with past practice, easy to apply and considerably more cost beneficial.⁹

We agree that for private companies, the Board should continue to allow the volatility input to be set at zero, or alternatively, should allow private companies to use the historical volatility of a broad-based index, such as the Russell 3000. We also believe that newly-public companies should be treated in the same manner because their future performance may likely bear little relationship to their performance in the years prior to becoming publicly traded, as should small public companies, whose stock is generally thinly traded. For all such companies, costs will be minimized, auditors can audit the number, and the result would be no less reliable than if the company paid purported experts significant sums to try to predict the volatility of a stock that does not trade, which only recently began to trade, or is thinly traded.

Binomial Model v. Black-Scholes

With respect to the issue of whether lattice models are more accurate than Black-Scholes, we believe that Professor Rubinstein has answered this question with a resounding “No.” The use of either Black-Scholes or a lattice model will simply provide hypothetical information that can never be confirmed or denied since there are no markets for employee stock options. Thus, while lattice models have the appearance of more precision, they, like Black-Scholes, were designed to value short-term, freely-tradable options and, accordingly, suffer the same fatal flaws.

⁹ TIC Comment Letter, June 7, 2004, (Letter No. 3085), at pp. 1-2.

Issue 4(d): Do you agree that the Exposure Draft gives appropriate recognition to the unique characteristics of employee stock options? If not, what alternative would more accurately reflect the impact of those factors in estimating the option's fair value?

Early Exercise Behavior

The primary adjustment to the binomial or Black-Scholes models permitted by the Exposure Draft is a reduction of the life of the option to reflect early exercise behavior. Yet for private companies, the Exposure Draft provides absolutely no guidance on how to estimate the expected life of the option based on early exercise behavior. For most private venture-backed companies, options are not exercisable unless and until the company goes public. As a result, venture-backed private companies would have to determine the early exercise behavior of employees who, by definition, could never have exercised an option.

If the Board were to reject Professor Rubinstein's admonition and, instead, insist on moving forward with existing option pricing models, some safe harbor option life, such as 36 months, should be established for private companies. The Exposure Draft's proposal that the early exercise behavior be determined based on different classes of employees also makes no sense from a cost benefit or practical standpoint for any company, but certainly not for private, newly-public, or small companies. For simplicity and cost efficiency all employees should be treated the same.

Other Unique Attributes of Employee Stock Options

Adjustment of the option life alone does not account for all of the other unique attributes of employee stock options. Without additional discounts to reflect the significant restrictions that exist, most importantly that options can not be hedged, nothing even approximating fair

value under a willing buyer-willing seller standard will be produced under either Black-Scholes or a binomial model, even if minimum value were used. What should these discounts be? We asked various prominent investment banks, and learned that they would not buy employee stock options that could neither be traded nor hedged, even where those options were issued by a public company with millions of shares trading every day. They certainly would not purchase options issued by a private company whose stock, like its employee stock options, is wholly illiquid. This is why we believe that the most appropriate measure of “compensation cost” for private companies is intrinsic value at grant date. For the reasons discussed above, we also believe that this treatment should be available to newly-public and small companies.

Issue 5: Do you agree that the intrinsic value method with remeasurement through the settlement date is the appropriate alternative accounting treatment when it is not possible to reasonably estimate the fair value?

No. And we do not believe that the Board does either. The Board has been clear from the beginning that the proper measurement date is the date of grant, with an adjustment for options that never vest. This new variable “intrinsic value” method is, in the end, exercise date accounting. For this reason alone we believe it is wholly inconsistent with a fundamental premise of the Exposure Draft – grant date accounting – and should be rejected.

Moreover, for private companies, numerous valuations of the underlying common stock (which does not trade, and in many instances is not even issued and outstanding) per year would be required, or at least there would have to be analytical support to justify no change in valuation. Like many public companies with broad-based plans, some private companies have monthly or daily vesting of their stock options. The simplistic examples in the Exposure Draft

do not reflect reality and imply that implementation of this method will reduce costs to private companies. Based on discussions with valuation experts and auditors, we believe that the costs to implement the intrinsic value model are indistinguishable from the costs that would be incurred to implement a fair value model. Accordingly, it would not serve its goal of simplifying the accounting or reducing implementation and compliance costs. We commend to the Board's attention Comment Letter No. 3085 submitted by the American Institute of Certified Public Accountants' TIC for an extensive discussion of this issue. The TIC believes that the variable intrinsic value method "will not provide more reliable data to users and will not be more cost-effective for preparers to implement. . . . TIC does not understand how changing from one flawed method to another at added cost will be in the best interests of constituents or accomplish the Board's objectives."¹⁰ The NVCA agrees with the TIC's views.

Issue 6: Do you agree that employee stock purchase plans are non-compensatory if the employee is entitled to purchase shares on terms that are no more favorable than those available to all holders of the same class of the shares?

Yes. However, we also believe that employee stock purchase plans that allow for a minimal discount for employees also are non-compensatory. When shares are purchased by employees, companies are not required to incur the significant costs associated with a public offering. Because these costs can differ based on any number of factors, the NVCA believes that the current rule of APB No. 25, which follows the tax rules as to what level of discount is considered non-compensatory, is appropriate. It provides consistency, simplicity, and recognizes

¹⁰ TIC June 7, 2004 comment letter, Letter No. 3085, at p. 4.

the cost savings that the corporation recognizes when unrestricted stock is purchased by an employee through an ESPP.

Issues 7, 8, and 9: Do you believe that the vesting period is the appropriate period over which to recognize any expense and do you agree with the Exposure Draft's method of accruing costs when a graded vesting schedule exists.

To the extent companies were to expense employee stock options, the vesting period appears to be a reasonable period. The NVCA, however, disagrees with the Exposure Draft's treatment of each separate vesting date as a separate grant of options. We don't believe that it will provide greater accuracy of expense recognition. As discussed above, any estimate of fair value is wholly hypothetical. Further complicating the recognition of any expense is not beneficial. For many venture-backed companies, whether private or newly public, options vest on a monthly or sometimes daily schedule and are granted to all or virtually all employees. Most of these companies do not operate in the manner set forth in the Exposure Draft's examples. Those examples illustrate the treatment where options are granted to one or only a limited number of executives. In addition, the expense in the examples is conveniently computed only at the end of each year, and a very simplistic vesting schedule is used.

The computations that would be required if a more realistic vesting schedule were illustrated would be extraordinary. For example, treating a company that issues options subject to a vesting schedule where 25% of the options vest at the end of year one and then options vest monthly for the next three years as 37 different option grants is tremendously difficult and costly to implement. Options granted every time a new employee joins a company would also have to be accounted for separately. We do not believe that any perceived benefit is justified by the increased time and expense that would be incurred, especially for private and newly public

companies, who lack the internal staff to perform all of the required computations and record-keeping and do not have the financial resources to hire outside experts to do the work for them.

Issue 10: Modifications and settlements.

No comment.

Issue 11: Income taxes.

The Exposure Draft's accounting for income taxes is problematic. To the extent the Board mandates or permits expense treatment, the income tax effects also should flow through the income statement. We believe that the Board must be consistent in its approach.

Issue 12: Do you believe that the disclosure objectives set forth in the Exposure Draft are appropriate and complete?

As discussed above, we believe that disclosure, and not expensing, is the appropriate treatment. Accordingly, in our view, disclosures that provide meaningful information are appropriate.

Issue 13: Transition: Do you believe that entities should be permitted to elect retrospective application?

Yes. We believe that many investors will demand this information. However, we believe an equally, if not more, significant transition issue relates to the effective date of any final pronouncement. For private companies, the NVCA believes the effective date of any new standard should be delayed significantly beyond any effective date applicable to public companies. Such a delay would allow the gathering of required data and development of new systems related to stock option awards, reduce the pressure on companies without sufficient internal staff to implement any new standards, and, perhaps most importantly, recognize that

private companies will be at the bottom of the list in vying for the attention of valuation and audit firms.

Issues 14(a) and 14(b): Election of the variable intrinsic value method and cost benefit analysis.

As discussed above, we do not believe that the variable intrinsic value method is either consistent with the remainder of the Exposure Draft from a theoretical standpoint or that it provides private companies with a viable and cost effective alternative.

With respect to implementation costs, we have had numerous discussions with valuation professionals and audit firms. Based on these discussions, we estimate that the annual cost to a typical venture-backed portfolio company of implementing either the “fair value” or the variable intrinsic value method set forth in the Exposure Draft will range from \$30,000 - \$100,000 in external consultant and auditor costs alone. Moreover, many portfolio companies do not have sufficient staff to do the additional work that would be required under the Exposure Draft, internally or the funds to hire additional highly trained and costly finance and accounting staff. Thus, in our view, the costs that would be imposed on private, newly-public, and small public companies far exceed any perceived benefits that could be derived if the Exposure Draft were finalized in its current form. Also see our discussion of this issue under Issue 5, above.

Issue 15: Should the rules applicable to private companies also apply to small business issuers?

As discussed above, we do not believe that the alternatives provided for private companies under the Exposure Draft are viable or satisfy a cost benefit analysis. If, however, private companies were permitted to use the intrinsic value method of APB No. 25 or some other

method that truly balances costs and benefits, then the NVCA believes that those rules also should apply to newly-public and small public companies.

Recommendations

There have been several new option pricing models developed recently and various adjustments proposed to Black-Scholes and binomial models which neither the Board nor its Options Valuation Group has considered. We believe that the most prudent course would be for the Board to examine fully and field test all of the various models on its proposed standard before mandating any changes to the existing stock option accounting rules.

Proposed Methodology for Private, Newly-Public, and Small Companies

One potential approach for private companies would be as follows:

- Continue to allow APB No. 25 intrinsic value at grant date accounting with appropriate footnote disclosures for all private companies. Newly-public and small public companies would be permitted to use the same methodology until they reach annual revenues of \$100 million (adjusted for inflation each year) or, if they exceed the revenue amount, have been listed on an exchange for 3 years.
- If the Board were to continue to allow the use of Black-Scholes or binomial models, such companies also would be required to provide footnote disclosures that include the theoretical value of their stock options. However, such companies would be permitted to make the following assumptions: set the volatility input at 0 or use the 10 year trailing volatility of the Russell 3000; use an assumed option life of 36 months; and, for private companies, allow the company's board of directors to establish the price of the

underlying common stock (with or without the aid of a valuation consultant as the board, in its sole discretion, determined).

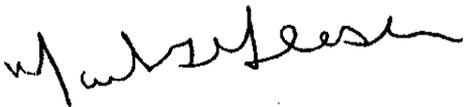
- Once a company were to become public and exceed either the revenue or years safe harbor described above, it would be subject to the same methodology applicable to large public companies, but only for newly issued options.
- If such a company were acquired by a public company, newly issued options, would be subject to the rules applicable to the acquirer.

The NVCA believes that our recommendation not only makes sense from a practical standpoint, but that it fulfills the Board's mission "to establish and improve standards of financial accounting and reporting for the guidance and education of the public, . . . auditors and users of financial information" at a cost that will not outweigh any perceived benefits.

Conclusion

Thank you for consideration of our comments. We would be pleased to discuss our views and recommendations with the Board in greater detail at the Board's convenience.

Sincerely,



Mark Heesen
President