

USVP

USA VENTURE PARTNERS

VIA Electronic Mail

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Director of Major Projects
File Reference No. 1102-100
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

**Re: Exposure Draft of a Proposed Statement of Financial Accounting Standards
Share Based Payment
An amendment of FASB Statements No. 123 and 95 ("Exposure Draft")**

We appreciate this opportunity to provide the Financial Accounting Standards Board ("FASB" or the "Board") with our comments regarding the Exposure Draft.

U.S. Venture Partners ("USVP") is the commonly used name used by a series of venture capital partnerships with approximately \$2.25 billion of committed capital. USVP was formed in 1981 and has invested in more than 300 public and private companies in a wide variety of industries across a broad spectrum of the development stages of an enterprise, from start-up to expansion capital. The members of our organization currently serve on the Boards of Directors of approximately 70 public and private companies. We believe that USVP would be considered a sophisticated investor and knowledgeable about financial statements and financial matters in general.

Summary Comment

As is outlined in more detail below, USVP does not agree with the conclusion that equity instruments awarded to employees ("stock options") necessarily give rise to measurable, recognizable compensation cost. Accordingly, we do not support the conclusions that:

- Such mathematically derived compensation costs should be reflected in the underlying financial statements of an entity issuing stock options, or
- The fair value of employee stock options can be more accurately measured with sufficient reliability, whether with a closed-form model such as the Black-Scholes-Merton formula, or with a lattice model, than with existing guidance set forth in APB Opinion 25 which requires the use of an intrinsic value method.

Our more detailed comments supporting these conclusions follow.

Issue 1: Conclusion that employee services are received in exchange for equity instruments and give rise to recognizable compensation cost.

Generally speaking, we understand that an expense is considered to have been incurred when a business entity is required to expend cash, dispose of an asset, or incur a liability in exchange for services or goods that will be expended in the process of obtaining or generating revenues, and that an expense is generally tied to the outflow of assets, primarily cash.

In our experience, the granting of an employee stock option has not resulted in the expenditure of cash, the disposal of an asset, or the incurrence of a liability by the entity issuing such stock options. We believe that the granting of an employee stock option provides a mechanism for the sharing of the market appreciation in the overall value of the enterprise between and among existing shareholders and the recipients of the stock option. Further, the ultimate realization of such appreciation in value is paid for by third-parties external to the issuing entity willing to pay cash to acquire the stock. In such transactions, no cash is expended by the issuing entity.

Accordingly, we do not conclude that the granting of an employee stock option generates the basic activity (the outflow from the business entity of cash, or another asset) that is required under the basic definition of an expense transaction.

[We are concerned that the Exposure Draft may ultimately promote a double standard. Specifically, market appreciation of the equity securities of a business enterprise is not, and we believe it should not be, reflected in the financial statements. However, the Exposure Draft would require that an expense be recorded when existing shareholders allow employees to acquire rights to share in that same market appreciation.]

Issue 3: Is "Fair Value" the relevant measurement attribute and is "Grant Date" the relevant measurement date.

Issue 4(b): Conclusion that the "Fair Value" of employee stock options can be measured with sufficient reliability (using either a closed-form model such as the Black-Scholes-Merton formula, or with a lattice model).

"Fair Value" has been defined by the Board as the price that would be agreed by a willing seller and willing buyer. In our experience, an employee stock option can not be sold as such options are not transferable. Recent experiences, such as the Microsoft and Coca-Cola examples, indicate there are no willing buyers of such employee stock options. Finally, we believe that "fair value" is ultimately measured based on the cash exchanged; in the case of an expense this would require a cash outflow from the business entity. As we have stated previously, we are not aware of a cash outflow from the entity associated with either the granting or the vesting of a stock option.

Based on our reading of the Exposure Draft we understand that "Grant Date" means the date on which an employee stock option award vests or the date that the requisite service period ends.

We recognize that some might argue that employee stock options are awarded in exchange for a reduction in the cash compensation paid to an employee. In such a case, the parties are theoretically saying "we mutually agree that the service being sold by the employee and purchased by the company has a value of \$X. In exchange for the performance of such services, the company will pay and the employee will accept \$X in cash. Alternatively, the company will

pay the employee with a lesser amount of cash (\$Y) and with stock options. If this were the case, the fair value of the stock option would be readily measurable as the difference between the cash payments of \$X and \$Y. This expense would then be recognized ratably over the relevant period that the compensation package was in effect.

As we understand the provisions of the Exposure Draft, there would be two significant differences from the approach described in the preceding paragraph. First, the date on which the value of the compensation package is measured would not be the date when the two parties agreed upon the terms of the compensation package, and the value of the compensation package would not be based on the value which the two parties placed on the services to be provided. Rather, the "fair value" of the stock options would be measured on the subsequent date(s) after the service is performed and the stock option is earned, and the "fair value" would be measured against the enterprise value on the date that the option was earned (utilizing either a closed-form model such as the Black-Scholes-Merton formula or with a lattice model).

The following simplistic example may be of some assistance.

Assume that XYZ Company ("XYZ") has two assets, a bank account with \$2 million cash and 1,000 bars of a commodity ("OPT") which XYZ recently purchased for \$2 million. There is no expectation that there will be any significant change in the value of OPT in the foreseeable future. XYZ expects that it will utilize (consume) the 1,000 bars of OPT in its business operations.

An agreement is reached between XYZ and Mr. Smith on December 15, 2000 that will require Mr. Smith to begin employment on February 1, 2001. Mr. Smith and XYZ agree that he shall receive \$120,000 annually for his service, and that payment will be made in the form of 12 equal monthly cash payments of \$8,000 (\$96,000 annually) and 1 bar of OPT at the time of each cash payment (a total of 12 bars annually).

At the date of their agreement (December 15, 2000), the compensation package is valued by the two parties at \$120,000 which implies a fair value of \$24,000 for the 12 bars of OPT (\$2,000 per bar of OPT); the \$24,000 is derived as the difference between the \$120,000 total cash that the parties would willingly exchange for the services and the reduced \$96,000 that will be exchanged in cash when the 12 bars of OPT are substituted for the remainder of the cash.

On February 1, 2001 Mr. Smith begins the requisite service. On February 28, 2001 Mr. Smith completes the first month of service and receives \$8,000 in cash and 1 bar of OPT. Assume that nothing has changed from December 15, 2000 and there is no information available to indicate that there is any change in the value of OPT. XYZ records compensation expense of \$10,000 consisting of \$8,000 in cash and \$2,000 as the value of the 1 bar of OPT that is given to Mr. Smith. Similar transactions occur on the last day of each of the next 8 months, and during this relevant period there is no information available to indicate that there is any change in the value of OPT.

In the tenth month of the relevant service period, conditions change and the external value of OPT has increased to \$5,000 per bar; it is not clear whether the conditions driving the value up are permanent. At the end of this tenth month, XYZ delivers to Mr. Smith \$8,000 in cash and 1 bar of OPT. What value does XYZ place on the 1 bar of OPT that it delivers to Mr. Smith? If it values the 1 bar of OPT at the current fair value of \$5,000 it will record an aggregate expense of \$13,000 with a corresponding \$3,000 of profit from the "liquidation, sale, or exchange" of the 1 bar of OPT. Or, one might argue that the 1 bar of OPT "was consumed" in the operations of XYZ, just like a raw material, and that the cost was the \$2,000 historical cost of the OPT. In either case, the net result is a \$10,000 charge to operations which is the same fair value of the services that was negotiated when XYZ and

Mr. Smith entered into their agreement. To complete the year, assume that the value of OPT returns to \$2,000 per bar in the last two months. Consequently, over the entire 12 month period, XYZ recognizes net expense of \$120,000, in 12 equal increments of \$10,000.

Now, let us modify the assumptions. Rather than receiving the 12 bars of OPT, XYZ and Mr. Smith agree that he will accept the same cash compensation of \$96,000 but will instead receive 12 options to acquire shares of XYZ stock. On the surface, given the factors noted here, it would appear that the two parties have valued the 12 options at an aggregate \$24,000. Over a 10 month period, XYZ would presumably recognize \$10,000 per month in expense, or a total of \$120,000 in expense in the 10 month period. However, if the Exposure Draft is followed, and let us assume for simplicity sake that the variables used in a binomial model are perfect and they match the market perfectly, 12 different option values would have to be estimated, one for each month of "vesting", the "fair value" of each month's vested option would have to be allocated to each of the periods preceding it. We estimate that the total expense during the 12 month period would be approximately [\$96,000 cash compensation plus \$27,000 of "fair value" attributed to the options=] \$123,000. Of the \$27,000 expense attributed to the options, nearly \$13,000 of it would be charged to operations in the first 3 months.

Thus, it appears to us that the value attributed to the employee stock options under the Exposure Draft is not based on "fair value" (defined by the Board to be the price that would be agreed by a willing seller and willing buyer), but rather more on a "theoretical value" which is derived using mathematical calculations which are not readily understood, utilizing variables which by their very nature are subjective, and that can never be ultimately measured against the actual outflow of cash from the business entity.

Issue 14(a) and 14(b): Impact on Nonpublic Entities

We are concerned with the potential impact of the Exposure Draft on nonpublic entities, and in particular upon early stage business entities. Although the Exposure Draft offers nonpublic entities the option of electing to use either the fair-value-based method or the intrinsic value method, the Exposure Draft requires that the intrinsic value method be applied essentially at each reporting period.

For an entity that is required to present GAAP based financial statements to a lender or vendor during the year (quarterly for example) this results in a significant burden. Generally, the external users of such statements are most concerned about cash flows of the entity. Management, the Board, and shareholders are equally concerned about cash flows and the overall control of expenses. The expensing of stock options does not help either user of the financial statement better understand cash flows (since there is no cash flow associated with the awarding of stock options), or control expenses (because the cost associated with the stock options is dependent upon factors generally outside of management control and the option award is made well in advance of the change in conditions driving the expense). Thus the effort expended to determine and value is essentially of no real value to these users of the financial statements.

We are even more concerned that a casual reader of the financial statements (one who is, for example, interested in understanding the basic expense and profit picture of an enterprise) could be materially misled as to the comparative profitability of an enterprise. As we have previously commented, we believe that Exposure Draft results in a charge to operations for some portion of the external market's perceived appreciation in the overall value of the enterprise. Thus, two enterprises with identical compensation packages for employees can experience significantly different expenses, based not on the actions of management or the services provided by

employees, but on the market's perception of the outcome of their efforts and the willingness of the market to either increase or decrease the perceived value of the enterprise. In a start-up or early stage enterprise, an entity making reasonable progress in the development of its product would seemingly reflect a higher cost structure because of the expense associated with stock options (the theoretical value of the options is higher because there is an appreciation in the value of the enterprise, driving the price of the underlying stock up) than an identically structured enterprise which the market has not judged to have made as much progress, and thus whose enterprise value as not increased. This is seemingly an expense penalty for success.

We are also concerned with the out of pocket cost associated with implementing the requirements of the Exposure Draft. These costs include the fees associated with the valuation experts who will be required to manage the process of deciding upon the subjective items that are required for the models and who will make the mathematical calculations, the increased cost of auditors who will have to satisfy themselves as to the reasonableness of the underlying assumptions and their use in the models, as well as the "hidden" internal costs associated with tracking the option activity, explaining the stock option expense costs to the users of the financial statements (such as vendors, landlords, and creditors), and the costs associated with likely renegotiation of financial covenants in various financial arrangements such as bank loans, lease lines and similar financial instruments. None of these costs will ultimately help improve the operations of the business enterprise.

Thank you for the opportunity to present our comments to you concerning the Exposure Draft of a Proposed Statement of Financial Accounting Standards -- Share Based Payment -- An amendment of FASB Statements No. 123 and 95. Should you have questions concerning our comments, please contact Mike Maher at 650.854.9080 or by e-mail at mmaher@usvp.com

Very truly yours,



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