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Director Of Major Projects
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, Connecticut 06856-5116

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Dear Sirs:

Warburg Pincus is a well-established private equity and venture capital firm. We manage over \$10 billion invested in a wide variety of industries, across the entire spectrum of the life of a company from start-ups to growth capital to acquisitions and restructurings. Our holdings are in private as well as public companies. Our investment activities are global as we have invested in over 30 different countries. Many people would consider Warburg Pincus a sophisticated investor, knowledgeable about financial statements and the workings of business around the world. Our partners currently sit on the Board of Directors of over 150 public and private companies, including as members of audit and compensation committees.

We appreciate the opportunity to comment on FASB's Exposure Draft regarding Share-Based Payments. We understand that the Board has worked extremely hard over the past few years, in a highly charged environment, to try to bring order to the question of whether and how to expense employee stock options.

Unfortunately, as outlined below, we believe that the Board's proposed changes will significantly reduce the usefulness of financial statements. Instead of making financial statements more user-friendly, comparable, consistent, accurate, transparent, credible, and simpler, we believe that the Exposure Draft guidelines will create the opposite effect, while adding a meaningful internal administrative and accounting burden for all companies.

We would endorse changing accounting treatment where the benefits were clear, and where the implementation methodologies were well understood, well-tested, and relatively easy to apply. We don't think those conditions exist with the recommendations in the Exposure Draft. In addition, we are concerned that adding another layer of complexity to already complex financial statements while forcing companies, both public and private, to endure another large administrative and accounting burden on top of Sarbanes-Oxley implementation, especially Section 404, will hurt U.S. companies.

New York Menlo Park London Munich Hong Kong Singapore Tokyo Seoul Beijing

Mumbai

Our experience as venture capitalists, active investors, and Board members suggests that the Exposure Draft changes will make stock options a considerably less desirable tool for incentivizing employees and aligning their interests with shareholders. Moreover, the loss of stock options will have serious negative consequences to the U.S. economy, the entrepreneurial economy, and small business.

Private Company Financial Statements

Some of the Board's comments, as reported in the press, acknowledge that the stock option expensing issue is significant only to public companies. In our view, to the extent that there is any validity to the argument that stock option expensing is justified, it should stem from the dilutive effect of the ownership on the public shareholders. But in the context of private companies, the shareholders, who are the only parties who actually bear the cost of the stock options, tend to be either sophisticated (to the point where they understand the true cost of options to a far greater extent than can be quantified by any model) or quite active in the business, as in the case of a closely held company. In these circumstances, it is difficult to see how the cost of implementing the changes contemplated by the Exposure Draft can compare to any theoretical benefit from imposing upon them this kind of regime.

We want to emphasize that financial statements prepared in accordance with GAAP are extremely important to private companies, and we respectfully remind the Board that many third party users of private company financial statements tend to be even less sophisticated than those reviewing the information on public companies. Summary numbers, such as "net income", "EBITDA" and "shareholders equity", take on tremendous meaning to private company financial statement users, especially those that are unsophisticated or do not have access to the detailed footnotes of audited statements, as with many who rely on credit reporting agencies. The constituencies that rely on private company financial statements include:

- 1. <u>Employees</u>. Most employees, or potential employees, of private companies lack access to the detailed financial records of the company, yet they want to understand whether they are joining an enterprise that is profitable, generates positive cash flow, has meaningful shareholders equity, etc. The proposed changes on stock option accounting will make it that much more difficult for this group to understand the answers to their simple questions.
- 2. <u>Customers</u>. Small private companies already are at a disadvantage today when competing against larger, established enterprises. Customers often want to understand the financial viability of their vendors before placing orders. The procurement department personnel of many companies lack the financial sophistication to dig into the details of companies' financial statements. The proposed changes on stock option expensing will make it that much more

difficult for this group to understand whether their supplier is financially viable or not.

- 3. Vendors. Before shipping product to small private companies, suppliers are anxious to understand whether they will get paid. They are less likely to sell product to unprofitable companies, or if they do, then they may not advance normal trade credit. The proposed changes for stock option expensing will make it more confusing for vendors to understand the financial portrait of their customers.
- 4. <u>Banks</u>. Many members of the banking community today, especially the smaller local and regional institutions, lack the sophistication and patience to create the pro forma numbers that give them comfort on the cash flow generating capacity of the underlying business. The Board's proposed changes may impact existing bank loan covenants (e.g., traditional net worth covenants, due to potentially volatile shareholders' equity). The proposed change in accounting treatment for stock options will require numerous small companies to renegotiate their existing bank covenants, which may entail meaningful incremental legal and banking fees. Unfortunately, we do not have the data to quantify this potential impact today.

None of these parties have reason to consider the "expense" of stock options to be relevant to the important questions for which they review the company's financial statements. In effect, the "expense" of a stock option does not, in any way, diminish the company's ability to satisfy its obligations to these parties.

Some members of the Board have argued in public comments that if the Exposure Draft guidelines are implemented, users of financial statements that want to adjust for the expense of employee stock options can back them out of their analysis. We believe that this is problematic, especially for private companies, where many users may not have access to the footnote disclosure in the financial statements, nor the sophistication, to complete the analysis.

We strongly urge the Board to reconsider its views before it requires changes that will have negative impacts on users of financial statements, negative impacts on issuers of stock options, and create an added administrative burden on private companies. We believe that the costs far outweigh the benefits.

ISSUE #1

In our opinion, recognition of employee stock options as an expense in the financial statements is inappropriate and misleading. Employee stock options are not a cost to the company, but a contingent (potential) reallocation of equity value between employee recipients and the shareholders. There is no expense to the company and no cash charge (ever) to the company. In fact, if exercised, the stock option will

prove to be a source of cash to the company. The Board argues that precedent accounting treatment requires recognition on the financial statements of expenses incurred by shareholders on behalf of employees. We do not believe that it reflects the actual arrangement between the various parties in this case. The Board states that there is an established practice that if a shareholder pays directly part of the cost of an employee's cash compensation that cost should be reflected in the financial statements of the company because such an omission would be misleading. We think that if a shareholder absorbs part of the cost (past or future), then it may be misleading to see it as a corporate expense. Moreover, even though it may be "established practice" to place this cost on the company's financial statements, we believe that "established practice" should not drive the rationale for expensing stock options.

Bringing the market share price of common stock into the P&L is a meaningful change for users of financial statements. For companies with broad-based employee stock option plans there are not many other items in the financial statements that have the potential to create shifts in reported income of the magnitude contemplated here. Moreover, nearly all other areas of GAAP allow some re-determination or adjustment as better information becomes available (e.g., changes to bad debt reserves, pension costs). To be clear, we are not recommending re-determination or suggesting variable accounting, only highlighting what appears to us as inconsistent accounting. Today, GAAP may not be 100% accurate in the short-term, but over time it reflects reality. This would no longer hold true if FASB implements the Exposure Draft.

ISSUE #2

We believe that full disclosure of the prospective cost of employee stock options will benefit all users of financial statements. Current FAS 123 requirements for broad-based footnote disclosure of the potential cost of employee stock options to shareholders is adequate for those who are making investment decisions. We would go further than the Board and suggest that sensitivity analyses be included in the footnote disclosure so that financial statement users can appreciate the range of prospective outcomes and the potential impact on the value of their shareholdings. The sensitivity analyses would give those analysts who want to better appreciate the potential impact or value of employee stock options the results under different assumptions for volatility, employee exercise behavior, etc.

If the Board insists upon including the expense of stock options in the financial statements, we recommend allowing pro forma disclosure to provide added visibility and to reduce potential confusion or misleading numbers that come from option pricing models. We also recommend that if FASB requires expensing that the Board allow separate line item disclosure of the employee stock option expense on the P&L and balance sheet, or on the face of the financial statements, so that users can easily understand this potentially large non-cash expense (similar to the treatment for depreciation and amortization).

ISSUE #3

To the extent that the "cost" of employee stock options are included in the financial statements, we do not believe that "grant date fair value" is the appropriate methodology. We do not believe that grant date is the correct time to start the clock because of the highly contingent nature of employee stock options. Instead we recommend recognizing the expense ratably over the time between when the stock option can first be exercised through its remaining exercise term because there is no realizable value to the stock option until the vesting conditions and the value conditions (i.e., the stock option is "in the money") are met. There is no intrinsic value that an employee can capture prior to meeting the above conditions of exerciseability and value. While there is some theoretical extrinsic value to the stock option, the employee can never capture this extrinsic value because the stock option is not transferable, and further vesting is contingent on an employee's active employment with the company. For clarification, we are not advocating variable accounting or a "mark-to-market" of the changes in intrinsic value over time.

We think that the term, "fair value", as it has been defined in the Exposure Draft, is a misnomer and an inaccurate characterization. At best, option pricing models provide a "theoretical value". "Fair value" as defined by the Board represents the price that would be agreed by a willing seller and a willing buyer. Employees cannot sell their stock options because they are not transferable and evaporate if the employee leaves the company. There are no willing buyers either, as recent examples such as Microsoft and Coca-Cola highlight. Even for these highly liquid stocks, options traders had no interest in owning employee stock options due to their numerous restrictions, the inability to hedge the positions, and their lack of liquidity. As part of our own investigation into this issue we asked a number of options traders at various Wall Street firms to place a value on employee stock options. They were consistent and universal in stating that they had no interest in making a market in employee stock options because the significant differences between tradable options and employee stock options made their option pricing models inappropriate.

ISSUE #4

Ten years ago the Board thought that Black-Scholes would provide accurate estimates of the value of employee stock options. That conclusion proved premature. We applaud the Board's reconsideration. Unfortunately, we do not believe that lattice models are a panacea either. We do not believe that option pricing models exist today that provide a reasonably accurate estimate of the value of an employee stock option. The Board's decision not to mandate their use, and their recognition that implementation may require modifications and adjustments implies that they understand these limitations. Black-Scholes and binomial models were designed for tradable stock options where there is a liquid market, where the positions can be hedged, where blackout dates that limit liquidity do not exist, etc. They require estimates of future volatility and future exercise behavior. For short-dated options

recent history may be a reasonable proxy for the future. For long-dated options, forecasting the future based on the past may lead to large errors (as FASB notes in the Exposure Draft). FASB obviously understands this conundrum given its guidance to practitioners on how they might choose to estimate future results. Moreover, these models are very complex to implement and only a few practitioners today have an understanding of how to populate them, explain their output, etc. This may lead to manipulation of results as users will have a degree of latitude on the inputs. Also, the auditors that have to opine on the financial statements lack the training or expertise for consistent application of the estimates required by lattice models. Finally, the requirement for numerous estimates, each compounding in the model could lead to a broad range of outcomes. We believe that the magnitude of these outcomes is likely to have a material impact on the stated net income of the company as underlying share prices fluctuate.

We are not aware of any other expense calculation that requires companies and their auditors to make so many forecasts of the future. Even the accounting for pensions and retiree benefits does not rely on the level of abstraction contemplated here. Accountants today have enough difficulty getting the historical costs accurate. In the litigious environment within which they work asking them to predict the future seems unfair. We recommend that FASB and the SEC provide safe harbors to provide consistency in the implementation of these proposed rules.

The use of lattice models moves accounting and accountants more into the realm of becoming forecasters of likely business performance. Instead of focusing their time and resources on accurately capturing the past performance of a business, it seems that FASB, through the expected value concept in these models, is moving accountants into a role that they may not all be equipped or competent to perform. Also, implementation of the Exposure Draft will create added potential liability for auditors (due to the risks in making the wrong estimates) that they are likely to try to mitigate by requiring their clients to obtain third party appraisals and valuations, creating further expense and administrative burden for companies¹.

ISSUE #4b

We agree with the Board that Black-Scholes and other closed-form models are not likely to provide reasonable outputs because they were designed for a different purpose. We do not believe that any of the models, including lattice models, will lead to reliable measurements. In fact, we believe that the measurements will be unreliable and therefore will meaningfully reduce the usefulness of financial statements. Black-Scholes has the advantage of relative ease of implementation.

¹ Based on our analysis to date incremental third party expense of \$40,000 to \$100,000 per year for small private companies and \$250,000 to \$500,000 per year for large public companies that use stock options.

Lattice models create flexibility but at the cost of significant added complexity. In our experience increased complexity does not always equate to better reliability or precision; often, complexity has the opposite effect. Complex models and formulae often provide a false sense of security. There is an old computer programmer saying "garbage in, garbage out" meaning that the validity of the output is only as good as the quality of the inputs. We are dubious that many of the inputs, as numerous as they may be, will be of sufficient quality to produce reliable outputs.

Lattice models require numerous estimates and judgments regarding the probability of individual events occurring. Academics often have no problem estimating any input for any model because their cost of being wrong is not as high. When making these estimates at a macro level, one might be able to draw upon a wealth of data to extrapolate numerous behaviors and trends. However, when applied to a more narrow sets of facts, with companies or industries that cannot access readily available statistical data, the estimation process presents significantly greater challenges. When one considers the need to satisfy a company's auditors, regulators and other third parties, the challenge increases materially. When people are held accountable or their money is on the line or there is litigation risk we believe that they will struggle to make these estimates.

The estimates needed to populate lattice models may <u>not</u> come with high degrees of confidence. As more estimates with low degrees of confidence for their accuracy are plugged into a model and then multiplied for each occurrence, the models move further from producing an accurate end product. The models produce a range of outputs that can be meaningful and material. When different companies within the same industry end up with significantly different results based upon their use of different models or different assumptions, the lack of comparability will not enhance the value of the statements to the users. We think the lack of confidence that financial statement users will find in the output of lattice models will seriously reduce the reliability and credibility of the financial statements. Hence, our conclusion that footnote disclosure, not income statement recognition, is the appropriate guideline.

Accounting and appraisal firms, compensation consultants, and academics stand to generate huge amounts of new business implementing the proposed Exposure Draft because lattice models will require companies retain meaningful outside assistance. We are not surprised that many of these groups support the Exposure Draft. Unfortunately, what will be a boon for these groups will create a deadweight on all U.S. companies without creating more accurate financial statements.

ISSUE #4c

Option pricing models all assume "expected" volatility, not historical volatility. As outlined earlier, if the stock options were short-dated, recent history might provide a useful proxy for future volatility. However, these models were not designed for long-dated stock options, especially those with the constraints of employee stock options.

Making an estimate of future volatility is easy. Making <u>accurate</u> estimates of future volatility is hard.

We believe that requiring companies and their auditors to estimate future volatility with a high degree of confidence is one of the material weaknesses with the Board's approach. This issue is compounded for private companies, and relatively new public companies, where historical data is not available or relevant. Recommendations in the Exposure Draft to rely on public company comparables or various stock market indices has the aura of reasonableness, but we believe that for many companies these benchmarks are inappropriate and unreliable. First, even within similar industries the range of historical volatilities can be significant. Second, over what period of time should companies look at in estimating historical volatility? The historical volatility for a ten year period often is meaningfully different than over a one year period. Third, what should new companies in a new industry use for a peer group? What should Genentech have used when it was created as the first biotech company, or eBay, or the first cellular phone service company? The ability to use stock market indices or public company peer groups for estimating volatility is likely to lead to inconsistencies between companies. In addition, some companies will have an incentive to "shop" for the metric that fits their desired result. Moreover, as companies and their competitive environment evolve it means that the "correct" index or peer group should also evolve leading to potential manipulation, and implementation problems for auditors. This issue highlights that current option pricing models are not sufficiently robust that they can provide reasonable estimates. Equally important, there is no mechanism in the Exposure Draft to remedy mistakes as companies and auditors gather more information, including actual performance.

ISSUE #4d

Models that rely on estimates of employee exercise behavior are even more likely to reduce the credibility of financial statements. We believe that accurately predicting employee behavior is very challenging. There are so many variables with different levels of correlation that all interplay in an employee's decision to exercise a stock option; the greater the number of estimates, the greater the probability that the final output will be inaccurate. Moreover, the administrative burden for companies to collect and work this data, coupled with the need for equally complex and expensive models suggest that companies will end up paying a lot for unreliable outputs. While we believe that many academics are not troubled by the need to make estimates, companies and auditors that incur liability for inaccuracy will have a significant problem.

ISSUE #5

We strongly disagree that the intrinsic value method with re-measurement is an appropriate accounting treatment. This approach will lead to variable accounting; a horrendous outcome that nearly all companies try to avoid:

- Variable accounting penalizes companies that perform well by reducing their reported income to reflect increases in their share price (i.e., the better the company performs, the lower its reported net income);
- 2) Variable accounting confuses users of financial statements including vendors, customers, employees, and investors that are looking for trends and comfort that a company has some consistency in its financial performance;
- 3) Credit agreements often require certain financial performance levels or metrics to avoid acceleration of loans. Variable accounting creates havoc in this regard. While, in theory, bankers can make adjustments to their language on loan covenants to omit the impact of these charges, it defeats the purpose of the financial statements if lenders require companies to keep their books one way versus a different way for other constituencies.

An alternative that creates variable accounting is not a real alternative. To the extent that the Board believes that grant date is the appropriate measurement date, there is significantly greater justification for the intrinsic value method alone, without having the value of the option adjusted over time. The uncertainty associated over the level of expense with re-measurement will discourage virtually all companies from adopting this approach. Accordingly, if the current Exposure Draft is enacted most private companies will have to implement "grant date fair value" which FASB implies is less reliable, and likely to be expensive to calculate.

ISSUE #6-11

No comment.

ISSUE #12

We believe that the footnote disclosure requirements should be broadened in place of recognizing employee stock option expense on the P&L. The readers of footnotes should get sensitivity analyses regarding different volatility and exercise behavior assumptions so that they can appreciate the range of potential outcomes given the lack of precision with the stock option pricing models as described under Issue #2.

ISSUE #13

Public companies, and private companies that expect to become public companies, will need to provide investors with historical financial comparisons. The Board's decision not to require retrospective application is helpful in that it limits the cost and administrative burden for companies, but it is illusory because these companies still need to collect this information and disclose it. Absent retrospective application, it will be hard for financial statement users to get a sense of perspective on the progress of a company.

ISSUE #14

See comments on Issue #5. In addition, for non-public companies the mark-to-market intrinsic value method makes an IPO more challenging, if not impossible. It makes the potential merger with a public company problematic as it could create variable accounting for the acquirer (which is unlikely to be desired) if the stock option program remained post-merger. Finally, it does not reduce the implementation cost substantially because many private companies will have to seek a third party appraisal of their common share price each reporting period to satisfy their auditors. This expense is likely to be similar to the expense and much of the administrative burden of implementing the "fair value" method.

Non-public companies, and their auditors, will have tremendous difficulty implementing "fair value" because they lack the data to populate binomial models, and in many cases the models require complete guesswork (e.g., a prediction of employee exercise behavior will have no basis because there is no history to draw upon, the underlying common shares often are illiquid, etc.). The Board already has commented that closed form models are not particularly robust methodologies and should be adjusted for estimating the expense of employee stock options.

If the Board decides to expense employee stock options, we recommend that they amend treatment for non-public companies as follows:

- 1) Extend the implementation time period by an extra year to allow private companies time to develop adequate alternatives for incentivizing employees, because stock options, as we use them today, will become very difficult for most companies to issue. Also, some companies will need extra time to renegotiate bank covenants so that they are not in violation. Moreover, with the expected crunch of work with few knowledgeable practitioners, and limited internal resources, non-public companies will need the added time to prepare. In the grand scheme of world events an added year for implementation will not jeopardize the sanctity of financial accounting.
- 2) Allow APB 25 treatment for companies with annual revenues below \$100 million. This threshold will place the added burdens of the Exposure Draft only on those companies that have reached a level of meaningful scale where they could afford the implementation costs.
- 3) Allow Boards of Directors to determine "fair value" (as a safe harbor for the accounting firms). This will limit third party expense and litigation risk, but allow Boards of Directors the flexibility to seek outside assistance if they choose.
- 4) If companies use intrinsic value prior to their IPO or acquisition by a public company, then allow them to switch to fair value for previously issued stock

options. This flexibility will allow better comparability across companies, while not creating variable accounting treatment for public companies.

ISSUE #15-18

No comments.

We are very concerned that the proposed treatment will have serious long-term negative implications for the credibility of financial accounting, the credibility of financial statements, and more broadly, will lead to serious impairment of the entrepreneurial economy in the U.S.

We urge the Board to reconsider its position, seek alternative valuation methods, and ensure through detailed field testing that it completely understands the ramifications and implications of its guidelines. Until that happens, we prefer the status quo.

We appreciate the opportunity to share our thoughts with the Board and hope that it will reconsider its proposed treatment for expensing stock options.

Sincerely,

Jeffrey A. Harris Managing Director