

June 28, 2004

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

**RE: TL Ventures Comment Letter to Exposure Draft of FASB Proposed Statement of Financial Accounting Standards: Share-Based Payment, an amendment of FASB Statements No. 123 and 95**

Dear Sirs/Madams:

TL Ventures (“TL”) appreciates the opportunity to provide its views on the Exposure Draft of FASB Proposed Statement of Financial Accounting Standards: Share-Based Payment an amendment of FASB Statements No. 123 and 95 (hereinafter, the “ED”).

TL Ventures is a leading national venture capital firm with \$1.4 billion of capital under management. Founded in 1988, TL has raised six funds, has invested in more than 200 emerging technology and biotechnology companies and has exited more than 120 of these companies, distributing in excess of \$1.4 billion in cash and securities to its partners. Focusing on early-stage private technology companies in the software, information infrastructure and services, communications and biotechnology sectors, TL typically leads or co-leads its investments. The ED is particularly troubling to early-stage investors in small, private companies, such as TL, in that, while it appears to allow for slightly different valuation methodologies and permits a longer phase in for implementation, it does not truly acknowledge the distinction in the cost-benefit, practicality of valuing, consumption of scarce resources, or materiality such a pronouncement has on smaller private companies, the back bone of the US economy. Instead it holds all companies, regardless of size, to standards that are fiercely debated, even for Fortune 2000 companies.

It is common practice for early-stage companies to issue stock options to employees to better align the employees' personal interests with the prospects of the company by giving them a right to participate in accretion in value that is realizable only upon the occurrence of future events that are contingent on significant changes in the company's business. It is virtually universal that, in these nascent businesses, all resources are devoted to the development of the company to prove its mission, strategy and product offering. During these earlier stages, the company does not have the resources to spend on qualified support staff or consultants to comply with the extensive ED requirements. These small companies tend to employ a junior assistant controller or similar level employee to maintain the books and records of the company, rather than a highly-qualified, sophisticated CFO. Financial resources at these companies are minimal. Moreover, in many cases, there is no market for the Company's equity interests, the securities are not held for sale in whole or in part, and few, if any, comparables to provide guidance on value, and clearly no experience with regard to price volatility, expected dividends and a pattern regarding the exercise of employee options, all of which are necessary to enable the company to comply with the ED requirements. The estimated \$20,000 to \$50,000 in consulting fees that would be required to value the enterprise and the underlying stock options each year represents a substantial burden for immature businesses. Finally, we do not believe the intrinsic method, as outlined in the ED, is a viable option for early-stage enterprises.

We think it is also important to focus on the needs of the users of the financials. Generally the primary users of these developing company financials include lenders and other investors/preferred shareholders, such as TL. As the primary user of these financials, we understand the dilution factor to the shareholders of issuing employee options. We do not consider it an operating expense of the organization or a factor in evaluating its operations. Any investor or lender to these developing companies specifically focuses on the organization's net assets, its primary source of repayment of the investment or debt and under the ED would be required to cumulatively track the impact of the ED over time and back it out to arrive at meaningful operating financial results.

**Recognition of Compensation Cost (Issues 1 – 2):**

*Issue 1 - The Board has reaffirmed the conclusion in Statement 123 that employee services received in exchange for equity instruments give rise to recognizable compensation cost as the services are used in the issuing entity's operations. Based on that conclusion, this proposed Statement requires that such compensation cost be recognized in the financial statements. Do you agree with the Board's conclusions? If not, please provide your alternative view and the basis for it.*

While TL acknowledges that, upon issuance of a stock option or grant, the recipient may have received an instrument of value, TL fails to understand how it is an “expense” of the enterprise. Rather, TL believes such options represent

“potential” future dilution to the value of other shareholders’ interests. Expenses of the organization typically require, at some juncture, the corporation to expend cash. A grant of stock issued or to be issued, represents neither a future cash expenditure nor an obligation of the company; therefore, by definition, it is not an expense. From a pristine viewpoint, TL believes expenses related to the operations of an organization should not be combined with non-expense items. Within the exhibits of the ED, the FASB compares options issued to shares issued to consultants for services rendered; thereby supporting its argument for expensing stock options. TL contends the consultant compensation example stated in the exhibits to the ED is not analogous to employee stock options for several reasons. First, employee options frequently are subject to vesting and may or may not be forfeited, a significant difference. If such options are forfeited, which is common and more likely in smaller early-stage enterprises, under the ED, the expense previously recorded is reversed, removing any cost of the services rendered. This seems inconsistent with the FASB’s argument that stock options reflect a cost for services rendered. The services were rendered - that has not changed. What has happened as a result under the ED is that the income statement (through compensation expense) and paid-in-capital are fluctuating upon the grant and forfeiture of the option, neither of which, even if accurately measured, reflects or affects the “core” business financial operations. This approach is misleading and confusing for the reader of the financial statements.

*Issue 2 – Statement 123 permitted enterprises the option of continuing to use Opinion 25’s intrinsic value method of accounting for share-based payments to employees provided those enterprises supplementally disclosed pro forma net income and related pro forma earnings per share information (if earnings per share is presented) as if the fair-value-based method of accounting had been used. For the reasons described in paragraphs C26-C30, the Board concluded that such pro forma disclosures are not an appropriate substitute for recognition of compensation cost in the financial statements. Do you agree with that conclusion? If not, why?*

For reasons noted in the response to Issue 1, TL disagrees with this conclusion. TL believes the grant of stock is not an operating expense. While TL does believe that some investors would prefer information regarding the “perceived” cost to the organization of such stock awards, the pro forma supplemental disclosures and disclosed in the footnotes currently required are more than adequate and appropriate as opposed to the contrived methods proposed in the ED. Those supplemental disclosures required such perceived costs to be included in pro forma “fully-diluted” earnings per share, reflecting the impact of the exercised vested options as of the measurement date.

TL further believes that any estimates included in the operating results of the financial statements to any organization should be reliable. The models required to be used under the ED have proven to yield materially inaccurate and, therefore, unreliable results. Accordingly, TL does not support such information being included in the operating results of an organization. Please refer to the response to Issue 4 (b) for additional comments.

**A. Measurement Attribute and Measurement Date (Issue 3):**

*Issue 3 – This proposed Statement would require that public companies measure the compensation cost related to employee services received in exchange for equity instruments issued based on the grant-date fair value of those instruments. Do you agree with that view? If not, what alternative measurement attribute and measurement date would you suggest and why?*

If the FASB believes that stock options are properly treated as compensation expense, TL believes it more appropriate to calculate the fair value of the employee services rendered in exchange for the equity instruments issued on the various vesting dates. As the FASB concedes in appendix C17, “various techniques are available for estimating the fair value of employee share options”, the FASB should consider the cost-benefit for those non-public entities with constrained resources. These private enterprises are also required to issue GAAP financials and no longer may apply the more simplistic “intrinsic value method” under Opinion 25. Instead, these smaller private companies are expected to estimate not only the value of the enterprise (for which there is typically no ready market or comparable and for which there may be no net value), but price volatility, dividends, likelihood of employees to exercise, etc. for which there is no history and no basis to predict future events. The only accommodation the FASB considered for non-public enterprises was a revised intrinsic value method, requiring variable accounting, which requires a revaluation of the fair value of the options upon each reporting period. Again, the intrinsic method under the ED is untenable for the smaller resource constrained organization with over-extended and usually less technically savvy back offices.

**B. Fair Value Measurement (Issues 4a –b, 5):**

*Issue 4(a) – This proposed Statement indicates that observable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used to measure the fair value of the equity and liability instruments awarded in share-based payment arrangements with employees. In the absence of an observable market price, this proposed Statement requires that the fair value of the equity share options awarded to employees be estimated using an appropriate valuation technique that takes into consideration various factors, including (at a minimum) the exercise price of the option, the expected term of the option, the current price of the underlying share, the expected volatility of the underlying share price, the expected dividends on the underlying share and the risk-free interest rate. Due to the absence of observable market prices, the fair value of most if not all,*

*share options issued to employees would be measured using an option pricing model. Some constituents have expressed concern about the consistency and the comparability of the fair value estimates developed from such models. This proposed Statement elaborates on and expands the guidance in Statement 123 for developing the assumptions to be used in an option-pricing model. Do you believe that this proposed Statement provides sufficient guidance to ensure that the fair value measurement objective is applied with reasonable consistency? If not, what additional guidance is needed and why?*

TL believes the guidance provided in the Statement is sufficient assuming: (1) the models provide accurate estimates of the presumed underlying costs of the options (please refer to TL's response to Issue 4(b)); (2) if there are comparables available from which to reasonably determine the enterprise value; and (3) other required data points can be ascertained with some degree of accuracy. Again, the requisite analysis and required information is most applicable, more readily determinable and more reliable for larger public organizations; for which there is a viable public market and historical precedent for the other data implicated by the models recommended under the ED. Again, private companies, and in particular, early-stage entities, often are not profitable, typically have no comparables and therefore any analysis utilizing such models is inherently, materially flawed, resulting in misleading and useless financials.

*Issue 4(b) – Some constituents assert that the fair value of employee share options cannot be measured with sufficient reliability for recognition in the financial statements. In making that assertion, they note the Black-Scholes-Merton formula and similar closed-form models do not produce reasonable estimates of the fair value because they do not adequately take into account the unique characteristics of employee share options. The Board concluded that fair value can be measured with an option-pricing model with sufficient reliability. Board members agree, however, that closed-form models may not necessarily be the best available technique for estimating the fair value of employee share options—they believe that a lattice model is preferable because it offers the greater flexibility needed to reflect the unique characteristics of employee share options and similar instruments. However, the Board decided not to require the use of the lattice model at this time. Do you agree with the Boards' conclusion that the fair value of employee share options can be measured with sufficient reliability? If not, why not? Do you agree with the Board's conclusion that lattice model is preferable because it offers greater flexibility needed to reflect the unique characteristics of employee share options? If not, why not?*

Please refer to TL's response for Issue 4(a). We believe there is sufficient public data to demonstrate that Black-Scholes and the lattice models tend to over-estimate the value of the stock options granted, regardless of the accuracy of the data utilized for the inputs. The models' inaccuracies derive from the various inputs required that fail to take into account illiquidity (*i.e.* non-transferability, black-out periods, and any 144 restrictions) and the inherent inability to predict future markets. However, Black-Scholes and lattice models tend to produce more accurate results for short-term widely-publicly traded options, the markets for which they were created. Employee stock options typically are not short-term instruments (vesting term usually extends several years) nor are they widely traded (usually restricted). TL is further concerned about the subjectivity of certain of the assumptions (*e.g.* volatility and the expected life) that can have a dramatic impact on the value of the options as well as on the financials, which significantly reduces the reliability and comparability of financials, again conflicting with the FASB's stated goal for the ED. Cisco Systems noted in its initial comment letter to the FASB that in a two-month period, the same Black-Scholes model would have rendered a result \$1.6 billion different for the same stock options. One would presume a widely traded, long-term publicly traded company such as Cisco would have clarity on the inputs required under the Black Scholes model to render a more accurate "fair value" for its employee stock options. While TL recognizes that estimates are inherent in financial reporting, the Cisco commentary and other examples illustrate the significantly misleading financial information that likely would result if the estimated fair value of employee stock options were required to be reflected in the financial statements of every company, whether public or private.

Moreover, under the ED, the estimated value of options, unlike other areas of financial reporting (*i.e.* pension expense, etc.), are never "trued-up". Because no independent verification of the original estimated expense ever occurs, the financial statements and the resulting equity rolled forward seem to be meaningless information.

*Issue 5 – In developing this proposed Statement, the Board acknowledged that there may be circumstances in which it is not possible to reasonably estimate the fair value of an equity instrument. In those cases, the Board decided to require that compensation cost be measured using an intrinsic value method with remeasurement through the settlement date. 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? If not, what other alternative do you prefer, and why?*

For several of the reasons articulated in its responses to Issues 1 – 4, TL believes the new "intrinsic value" method is inappropriate for the types of companies comprising TL's portfolio. As noted above, TL believes stock options are not analogous to compensation expense, but more appropriately represent a potential dilution to per share shareholder value. The intrinsic value method contemplated by the ED is a complete departure from the methodology required when using either the Black-Scholes or lattice models, requiring a revaluation each reporting period compared to an estimate at a point in time that is never trued-up. Which methodology does the FASB believe to be most appropriate?

It is confusing even for the financial sophisticate. How is the required disclosure more clear to or protective for the more typical investor, even if somewhat financially astute? Additionally, as previously noted, the private companies, which are more likely to utilize the intrinsic method under the ED, will be burdened, unlike their public company counterparts, with remeasuring the enterprise and the options each reporting period, adjusting compensation expense and paid-in-capital. Again, TL believes the current pro forma footnote disclosure of stock options is not only adequate; it is a more reflective of the “value” potentially transferred by shareholders.

**C. Employee Stock Purchase Plans (Issue 6):**

*Issue 6 – This proposed Statement establishes the principle that an employee stock purchase plan transaction is 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. Do you agree with that principle?*

TL agrees.

**D. Attribution of Compensation Cost (Issues 7 – 9):**

*Issue 7 – This proposed Statement would require that compensation cost be recognized in the financial statements over the requisite service period, which is the period over which employee services are provided in exchange for the employer's equity instruments. Do you believe that the requisite service period is the appropriate basis for attribution? If not, what basis should be used?*

Again, TL does not believe options are analogous to compensation expense, but does believe disclosure should be based on the term or vesting of options awarded.

*Issue 8 – Determining the requisite service period would require analysis of the terms and conditions of an award, particularly when the award contains more than one service, performance, or market condition. Do you believe that guidance to be sufficient? If not, how should it be expanded or clarified?*

TL has no comment.

*Issue 9 – The Board concluded that this proposed Statement would require a single method of accruing compensation costs for awards with a graded vesting schedule. This proposed Statement considers an award with a graded vesting schedule to be in substance separate awards, each with a different fair value measurement and requisite service period, and would require that they be accounted for separately. That treatment results in a recognition pattern that attributes more compensation cost to early portions of the combined vesting period of an award and less compensation cost to later portions. Do you agree with that accounting treatment? If not, why?*

Again, TL does not believe options are analogous to compensation expense. FASB's position requiring greater compensation to be recognized in the earlier years seems incongruous with options that ratably vest over time, or are back-end loaded. If the employee is earning (vesting) such options ratably, what is the justification for weighting more heavily in earlier years the perceived compensation expense? Typically, employee annual compensation increases over time, rather than declines.

**E. Modifications and Settlements (Issue 10):**

*Issue 10 – This proposed Statement establishes several principles that guide the accounting for modifications and settlements, including cancellations of awards of equity. Do you believe those principles are appropriate? If you believe that additional or different principles should apply to modification and settlement transactions, please describe those principles and how they would change the guidance?*

TL has no comment.

**F. Income Taxes (Issue 11):**

*Issue 11 – This proposed Statement changes the method for income tax effects established in Statement 123 as originally issued. The proposed method of accounting for income tax effects which also differs from the one required in the International Financial Reporting Standards (IFRS) 2, Share-based Payment. Do you agree with the method of accounting for income taxes established by this proposed Statement? If not, what method (including the method established in IFRS 2) do you prefer, and why?*

TL has no comment.

**G. Disclosures (Issue 12):**

*Issue 12 – Because compensation cost would be recognized for share-based compensation transactions, the Board concluded that it was appropriate to reconsider and modify the information required to be disclosed for such transactions. The Board also decided to frame the disclosure requirements of this proposed Statement in terms of disclosure objectives. Those objectives are supplemented by related implementation guidance describing the minimum disclosures required to meet those objectives. Do you believe that the disclosure objectives set forth in this proposed*

*Statement are appropriate and complete? If not, what would you change and why? Do you believe that the minimum required disclosures are sufficient to meet those disclosure objectives? If not, what additional disclosures should be required? Please provide an example of any additional disclosure you would suggest.*

TL believes the guidance is, and the input disclosures for determining fair value when utilizing the Black-Scholes and lattice models are, adequate; however, TL does not believe options are analogous to compensation expense and prefers the reliability and practicality, not to mention the efficiency, of the current pro forma footnote disclosure for determining the impact stock options may have on the company and its shareholders.

#### **H. Transition (Issue 13):**

*Issue 13 – This proposed Statement would require the modified prospective method of transition for public companies and would not permit retrospective application. Do you believe that entities should be permitted to elect retrospective application upon adoption of this proposed Statement? If so, why?*

TL has no comment.

#### **I. Nonpublic Entities (Issues 14a-b):**

*Issue 14 (a) – This proposed Statement would permit nonpublic entities to elect to use an intrinsic value method of accounting (with final measurement of compensation cost at the settlement date) rather than the fair-value-based method, which is preferable. Do you agree with the Board's conclusion to allow intrinsic value method nonpublic entities? If not, why not?*

Please refer to TL's response to Issue 5. Additionally, TL believes the FASB has not comprehensively considered the cost-benefit of such a requirement on all private companies or the utility of this information to the reader of the private company financial statements.

*Issue 14 (b) – Consistent with its mission, when the Board developed this proposed Statement it evaluate whether it would fill a significant need and whether the costs imposed to apply this proposed Statement, as compared to other alternatives, would be justified in relation to the overall benefits of the resulting information. As part of that evaluation, the Board carefully considered the impact of this proposed Statement on the nonpublic entities and made several decisions to mitigate the incremental costs those entities would incur in complying with its provisions. For example, the Board decided to permit those entities to elect to use either the fair-value-based method or in the intrinsic value method (with financial measurement of compensation cost at settlement date) of accounting for share-based compensation arrangements. Additionally, the Board selected transition provisions that it believes will minimize costs of transition (most nonpublic entities would use a prospective method of transition rather than the modified prospective method required for public entities). Moreover, the Board decided to extend the effective date of this proposed Statement for nonpublic entities to provided them additional time to study its requirements and plan for transition. Do you believe those decisions are appropriate? If not, why not? Should other modifications of this proposed Statement's provisions be made for those entities?*

Please refer to TL's response to Issue 5 and 14(a). While TL believes the FASB had the best of intentions, TL respectfully strongly disagrees both with the FASB's stated opinion on the ED's probable impact on private companies, the back-bone of the US economy and its tax base, and the utility of the information developed in with regard to such early-stage entities.

#### **J. Small Business Issuers (Issue 15):**

*Issue 15 – Some argue that the cost-benefit considerations that led the Board to propose certain accounting alternatives for non-public entities should apply equally to small business issuers, as defined by the Securities Act of 1933 and the Securities Exchange Act of 1934. Do you believe that some or all of those alternatives should be extended to those public entities?*

TL believes that publicly held small business issuers will have a hard time estimating the inputs required under the Black-Scholes or lattice models and, accordingly, believes other alternatives offered to the private companies should be offered to their public peers.

#### **K. Cash Flow (Issue 16):**

*Issue 16 – The Board decided that this proposed Statement would amend FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits, as defined by this proposed Statement, be reported as a financing cash inflow rather than as a reduction of taxes paid. Do you agree with reflecting those excess tax benefits as financing cash inflows? If not, why not?*

Because TL does not believe employee stock options represent compensation expense, it disagrees with the ED presentation in the Statement of Cash Flows.

**L. Differences between This Proposed Statement and IFRS 2 (Issue 17):**

*Issue 17 – Certain accounting treatments for share-based payment transactions with employees in this proposed Statement differ from those in IFRS 2, including the accounting for nonpublic enterprises, income tax effects, and certain modifications. Those differences are described more fully in Appendix C. If you prefer the accounting treatment accorded by IFRS 2, please identify the difference and provide the basis for your preference. If you prefer the accounting treatment in the proposed Statement, do you believe that Board nonetheless should consider adopting the accounting treatment prescribed in IFRS 2 in the interest of achieving convergence?*

TL has no comment.

**M. Understandability of This Proposed Statement (Issue 18):**

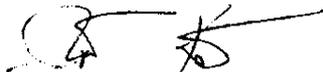
*Issue 18 – The Board's objective is to issue financial accounting standards that can be read and understood by those possessing a reasonable level of accounting knowledge, a reasonable understanding of the business and economic activities covered by the accounting standard, and a willingness to study the standard with reasonable diligence. Do you believe that this proposed Statement, taken as a whole, achieves that objective?*

TL does not believe the ED, as proposed, will enable the FASB to achieve its articulated objectives. Instead, TL posits that the ED will result in less reliable, less meaningful financial statements. We cannot recall any other standard previously adopted that requires financial statements to commingle expense items with non-expense items, or employ formulae proven to consistently render materially incorrect estimates. We frankly are surprised at the FASB's unyielding position; and its naiveté regarding both the impact of this proposal on the small businesses and the limited viability of the proposed intrinsic value alternative for private enterprises. We can only surmise the significant pressure the FASB has been under to set a standard in this area; nonetheless, we believe the ED, if implemented, would serve only to lessen the credibility of GAAP financial statements by further degradation GAAP earnings and paid-in-capital for all the reasons articulated above.

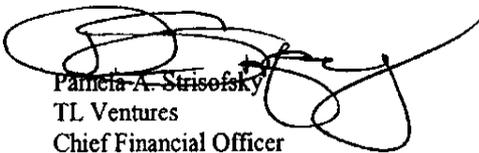
Further TL is greatly concerned that there has been no formal study of the impact the ED may have on the small companies and the US economy. We believe it incumbent on the FASB (perhaps rising to the level of a fiduciary obligation), as the promulgator of accounting rules, to fully comprehend, analyze and justify the overall impact of its pronouncements prior to implementation and national adoption as generally accepted accounting principles, and tailor them accordingly.

We again appreciate the opportunity to respond to the ED and would be pleased to assist you in any way we can. Should you desire further elaboration on these comments, please feel free to contact us.

Sincerely,



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