

Leapstone

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June 16, 2004

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

**Letter of Comment No: 4169**  
**File Reference: 1102-100**

**Re: Comments on Exposure Draft –Share Based Payment**

Dear Sir:

I am writing to comment on the March 31, 2004 Exposure Draft amending FASB statements No. 123 and 95 (“the proposed Statement”). For purposes of context, please note I am the Chief Financial Officer of Leapstone Systems, Inc., a privately owned communications software company. As of our fiscal year ending December 31, 2003, we are accounting for stock based incentives in accordance with APB Opinion No. 25. We have adopted the disclosure standards of SFAS No. 148 to provide pro-forma net loss and earnings per share disclosure as if the “fair value-based method of accounting for stock options had been applied.

**General Comments**

As indicated in Appendix C, the objective of the proposed Statement is to provide a basis for higher quality, transparent financial reporting stemming from financial reporting failures related to compensation over the recent years. Underlying this is an overall objective for greater consistency and comparability across financial reports. I do not believe that the proposed Statement will be successful in meeting any of these objectives. Perhaps more importantly I do not see how the proposed Statement would help investors make more informed and better investment decisions. In fact, trying to condense all the complexity of equity-based incentives into a single reportable compensation expense figure, using a myriad of assumptions and various theoretical black box models, cuts directly against the stated objectives. I also must point out that in Appendix C it is mentioned that the attention of investors, regulators and others to this area have been caused due to among other reasons allegations of misconduct by executives. It is impossible though, to really think that any of the provisions of the proposed Statement will thwart executive misconduct. I also cannot believe that the proposed Statement will provide for better oversight by the compensations committees of boards or result in better designed compensation programs that more closely align the interests of investors with those of employees. Finally, I do think the proposed Statement will open-up an area of continuing accounting controversy with consequent litigation and increased legal liability; (did Company x overstate or understate their reported earnings based upon compensation expense calculated using the correct or perhaps incorrect expected volatility which was input into the correct or perhaps incorrect option pricing model). Ironically, for those senior corporate officers inclined to misconduct and financial manipulation, the proposed Statement provides a new sand-box.

This is not to say the stated objectives are wrong. Given the increased focus of investors and regulators in the area of compensation and incentives, the objectives are on point. But what is needed is better quality, transparent, plain-English financial disclosure. For example it is generally difficult or even impossible for an investor to obtain among other items, 1) a condensed capitalization table where one can easily determine the percentage ownership represented by the pool of equity incentives relative to overall equity outstanding, 2) a view of how much of the pool is actually outstanding, 3) the vesting terms of the equity incentives and the actual vesting schedule, 4) the distribution of equity incentives for the top senior executives relative to the remaining employees and 5) strike or grant prices of the equity incentives (see attached examples). Certainly such disclosure could include fair value estimates based on an option pricing model for those who think this is relevant. My key point, however, is the type of disclosure I am summarizing will better and more transparently meet investors' needs. It would presumably in one section of the footnotes provide investors with information to determine how well their interests are aligned with the senior executives and the general employee population and if the company is successful in creating increased sustainable value, how much of that value accrues to the employees versus investors.

### Comments on Selected Specific Issues

#### Issue 1

I do not agree with the Board's reaffirmation that equity incentives for employees give rise to recognizable compensation cost. I think the Board is re-characterizing what is fundamentally a capital (balance sheet) entry on to the income statement. The arguments embedded in C13-C15 assume firstly, that the amount of cash compensation to employees would be the same with or without equity based incentives. My view is that certainly in a private company such as Leapstone (and even in a large public company); cash compensation would have to be higher if we did not provide an opportunity to participate in equity appreciation. Thus, an asset (cash) is retained in the company in effect as if equity was purchased. Secondly, at a more basic level, I disagree with the contention in C13 that employee services are momentary assets only and therefore should be expensed. I understand that GAAP doesn't capture any lasting value of a company's workforce but that is a shortcoming of the accounting rules not the underlying concept. (It is worthwhile to point out that in an asset purchase transaction; a company attributes value to a workforce which then is captured as an asset on the balance sheet). The concept here which I see as intuitive is that employees are an asset of a company and indeed a critical asset for technology and services businesses such as Leapstone. Put differently, no rational investor or buyer would pay the same price for the equity of Leapstone with or without its current employees as C13 suggests. And if Leapstone was purchased under an asset purchase arrangement there would have to be balance sheet recognition of the value of the current workforce.

The paradox of Issue 1 is that the rationale for providing equity incentives is on one hand to reduce real (cash) compensation expense and on the other hand tie-in the employees as important assets to the company. The observation that the pool of equity incentives tends to be proportionately larger for technology and services companies is not a statistical quirk. It is a very concrete recognition by the marketplace that employees in these organizations are not just important but critical assets and have to be tied very closely to the business.

To re-state my view, I think the proposed statement re-characterizes what is fundamentally a balance sheet entry on to the income statement.

Issue 2

I do not agree with the Board's conclusion. I have no specific objection to providing supplemental disclosure related to fair value based methods. As stated though, in my comments regarding Issue 1, I believe much more meaningful footnote disclosure should be implemented. The conclusion that compensation expense based on fair value methods should be recognized in the financial statements rests on the Board's reaffirmation under C26 that compensation costs from awards of equity instruments to employees . . . qualifies for recognition in the financial statements. The argument is entirely circular. Since I don't agree with the Board's reaffirmation, I cannot agree with its conclusion in Issue 2.

Issues 4(a)-4(d)

I am very troubled by the overall approach to fair value measurement. The crux of the proposed approach is estimation (using one of various models) because observable market prices don't exist. But therefore since observable market prices don't exist one can never determine the accuracy or otherwise stated, the validity of the fair value estimate which is being reported. Furthermore my experience to date in working with various option valuation models does not support the conclusion that there is any level of internal consistency among the models. Given the same inputs, the models do not arrive at similar estimates of fair value or even explainable differences. Finally, using expected volatility as one of the (most important) inputs seems extraordinarily problematic. Predicting a normalized co-variance of an individual security against a market index might be an interesting econometric research project but a bit far a field from the province of financial officers and auditors.

Issue 14a

As I understand it, the proposed statement allows non-public entities to elect intrinsic value method at each reporting date versus fair value at grant date. Thus, as a practical matter electing the intrinsic value approach becomes administratively burdensome variable accounting. Moreover, for a private company, the distinction between fair value and intrinsic value is ill-defined since in most cases market prices in any form don't exist. Overall, I do not know why the Board is making the grant date versus reporting date distinction and I would suggest (assuming we are heading down this path in any event) grant date valuation under either valuation method.

Conclusion

I appreciate that there could be and are legitimate conceptual differences regarding this topic. I would urge the Board to look back to the 1994/1995 time period to review why this issue was so divisive then, and then review again the pertinent issues independent of today's charged politicized environment. I would hope and urge the Board to come to an approach based on very practical considerations as to what information will provide company stakeholders with a better ability to make investment decisions. I certainly believe better, more easily understood plain English disclosure is the only direction that makes practical sense.

I appreciate the opportunity to be able to provide comments regarding this important topic.

Sincerely,  
Jack Skydel  
Chief Financial Officer  
[jskydel@leapstone.com](mailto:jskydel@leapstone.com)

### Summary Capitalization Table

	Number of Shares	Voting % Owned	Fully Diluted % Owned
<u>Preferred Stock</u>			
Series A	10,000,000	7.69%	6.67%
Series B	20,000,000	15.38%	13.33%
Total Preferred Stock	30,000,000	23.08%	20.00%
Common Stock	100,000,000	76.92%	66.67%
Total Voting Shares	130,000,000	100.00%	86.67%
Warrant Issued on Preferred	5,000,000		3.33%
Options Granted	7,000,000		4.67%
Remaining Options	8,000,000		5.33%
Total Options	15,000,000		10.00%
Total Fully Diluted Shares	150,000,000		100.00%

**Schedule of Options - Vesting Terms for Executive Team**

	<u>Number of Options Issued</u>	<u>Vesting Terms</u>	<u># Vested @ 12/31/02</u>	<u>% of total</u>	<u># Vested @ 12/31/03</u>	<u>% of total</u>	<u># Vested @ 12/31/04</u>	<u>% of total</u>
CEO	15,500,000	15.5 mm shares monthly beginning April 1, 2002 over 48 months	2,906,250	19%	6,781,250	44%	10,656,250	69%
President	1,750,000	400 k vested monthly beginning April 1, 2001 over 48 months	175,000		275,000		375,000	
		100 k 25% vested on May 1, 2002, 37.5% on May 1, 2003 & 2004	25,000		69,250		100,000	
		1.25 mm vested monthly beginning April 1, 2002 over 48 months	234,375		546,875		859,375	
			<u>434,375</u>	25%	<u>891,125</u>	51%	<u>1,334,375</u>	76%
CFO	1,750,000	1.75 mm shares monthly beginning April 1, 2002 over 48 months	328,125	19%	765,625	44%	1,203,125	69%
CTO	700,000	200 k monthly beginning October 1, 2001 over 48 months	62,500		112,500		162,500	
		50 k - 25% vested on May 1, 2002, 37.5% on May 1, 2003 & 2004	12,500		34,625		50,000	
		450 k vested monthly beginning December 1, 2002 over 48 months	9,375		121,875		234,375	
			<u>84,375</u>	12%	<u>269,000</u>	38%	<u>446,875</u>	64%
VP Engineering	600,000	200 k monthly beginning January 16, 2002 over 48 months	62,500		112,500		162,500	
		50 k - 25% vested on May 1, 2002, 37.5% on May 1, 2003 & 2004	12,500		34,625		50,000	
		350 k vested monthly beginning December 1, 2002 over 48 months	7,292		94,792		182,292	
			<u>82,292</u>	14%	<u>241,917</u>	40%	<u>394,792</u>	66%
VP Sales & Mktg.	500,000	200 k monthly beginning October 1, 2001 over 48 months	62,500		112,500		162,500	
		50 k - 25% vested on May 1, 2002, 37.5% on May 1, 2003 & 2004	12,500		34,625		50,000	
		250 k vested monthly beginning December 1, 2002 over 48 months	5,208		67,708		130,208	
			<u>80,208</u>	16%	<u>214,833</u>	43%	<u>342,708</u>	69%
	<u>20,800,000</u>							
		Grand Total	3,587,500	17%	8,398,125	40%	13,175,000	63%