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Director of the FASB
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File Reference No. 1102-100

Letter of Comment No: 4173
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Dear Sir,

RE: FASB EXPOSURE DRAFT
SHARE-BASED PAYMENT AND AMENDMENT OF FASB STATEMENTS NO. 123 AND 95

As President of Azea Networks, Inc. and CEO of the company's operating subsidiary in the UK, I am strongly opposed to the above draft. Despite lengthy consideration, I do not believe that the draft has adequately addressed the flaws in current valuation methodologies, nor has it provided a compelling rationale for the mandatory expensing of stock options. Below I have set out my basis for this belief, particularly in relation to non public companies such as venture-funded start-ups.

Firstly, in my view employee stock options do not constitute a true operating expense to the company. While it is certainly true that they have a potentially dilutory effect on the earnings and value of the company, this may be accurately and properly reflected in the financial statements via appropriate calculations of per-share metrics that factor in the total option count. This accounting methodology achieves full disclosure without distorting the company's cashflow or expense position.

This is particularly critical in the case of early stage start-ups where, in order to effectively motivate employees in a high-risk environment, the option pool may be a large percentage of the total capitalisation. In such companies, venture investors are primarily interested in the fundamental financials of the company, and the introduction of option expensing merely serves to obscure these underlying fundamentals. Such investors are well accustomed to the practice of predicting their effective returns based on the company's true economic health, and then taking into account the dilution caused by employee options.

The situation is exacerbated by the difficulty of determining an accurate and acceptable method of valuation for stock options. The Black-Scholes and binomial methods proposed for fair value estimation are both widely acknowledged to be problematic when applied to employee options. For non public entities, the current standard (minimum value) has been specifically disallowed – despite offering a comparatively simple and deterministic valuation methodology. The new proposal of a modified intrinsic value method is fraught with problems: most critically, it requires recalculation of the expense every reporting period, creating variable accounting treatment as the stock options are marked-to-market.

This period-to-period recalculation is particularly problematic for early stage start-ups, where the expense calculated by this method could easily overwhelm the underlying (true) profits of the company. Moreover, it could well result in farcical situations whereby a company in a deteriorating market would calculate a reduced intrinsic value for outstanding options, and thereby report a negative expense that reverses an underlying loss!

Further, the proposed method takes no account for the fact that common stock in venture-funded start-ups typically has restrictions imposed on re-sale, hence not only is there no public market for the stock but there is in fact no liquid market at all.

The proposal does not appear to have given sufficient consideration to the cost of compliance. The Black-Scholes and binomial methods are well known to be highly complex and hence companies are likely to incur significant costs in hiring external advisors to calculate them (not to mention the internal cost as a result of senior management spending substantial time understanding arcane formulae) – all for a result that is virtually meaningless due to its heavy dependence on certain key assumptions (such as volatility). For non public companies, the proposed modified intrinsic value method will potentially imply even greater costs, due to the need for recalculation every period.

On a macroeconomic level, I do not believe that FASB has given any consideration to the negative impact an expensing rule will have on the nation's economy. In addition to complicating cross-border comparisons of profitability with comparable foreign companies, the cost and complexity of implementing these inaccurate valuation methods will create a significant burden on US start-ups that will constrain their ability to compete on a global scale. The flow-on implications of this could be extreme, threatening the general view of the US as the entrepreneurial hub of the world. For example, since Azea's primary operations take place outside the US, this burden would inevitably lead us to re-consider our incorporation in the US.

Finally, I believe FASB's proposal, if enacted as proposed, will ultimately undermine stock options as a tool that has successfully aligned the interests of shareholders with employees. Azea currently grants stock options to all employees in order to promote an "owner's view" of the company. I firmly believe in this philosophy – not only because it benefits the company, but also because it enable a fair environment in which all employees share in the value they help create. The FASB's proposal would make the cost and complexity of maintaining this approach unsustainably onerous, and hence (as stated above) would likely force us to relocate our parent outside the US.

In short, I am steadfastly opposed to this draft.

Yours sincerely,

Scott White
Azea Networks, Inc.