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Letter of Comment No: 4162
File Reference: 1102-100

From: jdirvin@austinventures.com
Sent: Wednesday, June 16, 2004 7:46 AM
To: Director - FASB
Subject: Expensing Employee Stock Options – File Reference No. 1102-100

June 15, 2004

Director Financial Accounting Standards Board
Re: File 1102-100
Expensing of Employee Stock Options

I would like to offer comments regarding the proposed standard for expensing stock options – FASB Statement No. 123. My comments are general in nature and touch on several of the issues for comment outlined in the exposure draft.

To begin with, I don't believe stock options are an expense as declared in the exposure draft. Unlike other non-cash charges that can ultimately be tied to a cash-based transaction at some point in time, stock option expense never results in an out-of-pocket cash outlay for a company. I believe stock options represent a potential transfer of ownership that, if it occurs, would be a capital account transaction, not an income statement event, and the potential transfer is adequately comprehended in the denominator of the earnings per share calculation. Having said that, the rest of my comments address the proposed standard assuming that stock options do represent an expense.

In my opinion, one of the critical requirements that the proposed standard must satisfy is that the benefits of the standard must exceed the costs. This belief appears to be consistent with the perspective of the FASB as outlined in section C40 of the exposure draft. While it appears that meaningful effort has been expended by the FASB to quantify the potential costs and benefits of the proposed standard, section C40 concedes that “... *the value of that incremental improvement to financial reporting and most of the costs to achieve it are subjective and cannot be quantified.*” Obviously, the conclusion from the FASB's own cost/benefit analysis is that the benefits of the proposed standard outweigh the costs and the standard should be implemented. The conclusion I have come to is the opposite. The following is my perspective on these costs and benefits and my recommendation regarding the proposed standard.

Costs

To comply with the proposed standard, I believe companies will incur at least three different kinds of costs.

- Upfront cost for the procurement and implementation of software/hardware tools to manage data and perform calculations to enable compliance;
- On-going expense of collecting necessary data – like volatility data and employee behavior information;
- On-going expense of rationalizing that data, performing calculations and securing audit approvals.

It is likely that companies will incur some of the costs above whether or not the proposed standard is implemented because of the disclosure requirements in the current standard. However, I believe that these costs will be much higher if companies are forced to include fair value stock option cost in their income statement and balance sheet. In particular, I believe that the third type of cost will go up substantially upon implementation of the proposed standard. Given the magnitude of potential impact that stock option expense may have on earnings for many companies and the certification requirements of Sarbanes-Oxley, I believe the quarterly calculation of stock option expense will get a great deal more attention from senior company management and company outside audit staff if the proposed statement is adopted. Given the number of subjective judgments used for calculating “fair-value” stock option expense and the sensitivity of the calculations to these judgments, significantly more rationalization and debate will be expended by both constituencies in order to reach consensus. I believe the real dollar cost (auditing expense) and opportunity cost (management time) associated with this effort will be massive on a relative basis for a large percentage of companies.

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Benefits

I believe section C40 of the exposure draft provides the most succinct description of the FASB's benefit proposition regarding the proposed statement – “... *investors and creditors ... and other users of financial information benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.*” What is not clear to me from the exposure draft is how the implementation of the standard will result in improved financial reporting. In my opinion, I believe the standard will create the following three problems which will result in financial information that is less valuable to investors, creditors, etc., will harm markets, and will yield a less efficient allocation of resources in the economy.

1. Financial results will provide less performance transparency.

As investors attempt to value investments, particularly using discounted cash flow methodologies, the proposed standard creates two new problems for them. First, since stock option expense is a non-cash event, the expense must be extracted from the income statement, balance sheet and cash flow statement. While it is proposed that total stock option expense amounts be disclosed in the footnotes to facilitate that exercise, it isn't provided in the line item detail (i.e. COGS, Sales and Marketing, G&A, R&D, Inventory, Fixed Assets, etc.) that many investment professionals use to model future financial performance for a company. Consequently, I believe the proposed standard makes it harder to extract useful information from financial results to drive investment decisions. I also believe that the proposed standard would place a particularly unfair burden on the small/individual investors who may not have the resources to do this additional work.

2. Financial results will become less comparable across companies

With implementation of the proposed standard, financial results across companies become less comparable for a number of reasons. First, Black-Scholes and Lattice fair value calculation methodologies deliver meaningfully different results and companies can use either. I think that the FASB would agree that the results are meaningfully different or they wouldn't have recommended one over the other. Second, as mentioned earlier, both fair value calculation methodologies require numerous subjective inputs – like future volatility and employee exercise behavior – that can have a dramatic impact on the expense result. This subjectivity necessarily implies variability across companies and also provides an opportunity for manipulation, which, in light of recent events, is something we all would like to avoid.

On a comparables basis, the proposed standard could actually become a significant burden for younger companies. Take for example two companies operating in the same industry that both utilize a comparable stock option program. One company is very mature, has been around for many years, isn't growing very fast, and whose stock price doesn't fluctuate much. The second has just gone public, is growing fast, and the stock price is rising quickly. Unlike the first company, the second company will likely have to use the Black-Scholes methodology since it lacks the history to make the required assumptions regarding employee behavior to use the Lattice model. Given that Black-Scholes in general generates greater stock option expense, coupled with higher volatility associated with a growing stock price; it seems to me that the younger company will end up with a significantly greater stock option expense relative to its operating performance than the more mature company. It is challenging enough for younger companies to compete with more mature companies; I don't think we should make it any harder by strapping disproportionate stock option expense across their backs.

3. Financial results will likely be more volatile and less comparable across time.

Given the magnitude of the impact on earnings that the proposed standard may have and the degree of subjectivity associated with many of the expense calculation parameters, it seems likely that the proposed standard will yield financial results which are more volatile and less comparable across time for a given company. I'm concerned that potentially higher risk premiums will be placed on equity investments, which will depress stock prices in general and reduce the ability of companies to raise capital.

In addition, given that stock prices of all companies are subject to market forces and can vary significantly independent of company performance, I think we can assume that the volatility parameters used to calculate fair value stock option expense will be driven by these market forces as well as company performance. Consequently, I have to assume that company earnings will fluctuate over time based on these outside forces independent of performance. Given how volatile the market has been over the last few years, it appears to me that company earnings adjusted for stock option expense could fluctuate over time as a function of these market forces. If this is true, I conclude that the proposed standard will make it more difficult for investors and creditors to assess company performance trends – what amount of earnings variability should be attributed to company performance vs. what amount to the S&P 500?

Other Considerations

Beyond the cost/benefit analysis, I have three other concerns regarding the proposed statement. First, I worry about the potential impact that the proposed statement might have on company decisions regarding the issuance of stock options. I believe that stock options create tremendous incentive for entrepreneurship in our economy. I define entrepreneurship not only by the activity of starting new companies, but also the activity of starting new initiatives in established companies. As a partner in a venture capital firm, it is clear to me that stock options have played a key role in the development of the US technology industry – which today is the best in the world. In order to avoid the costs and complexity of complying with the proposed standard, companies may choose to stop offering options, or only offer options to very senior executives, or chose not to offer performance based options. In my opinion, any of these outcomes could have a meaningful negative impact on our economy over the long term.

Second, while I have tried to avoid getting into the details of the proposed standard, I feel compelled to share my thoughts regarding the requirement for “graded vesting”. If I understand the rule correctly, if a company grants an employee an option of 100 shares with a three year vesting term (1/3 per year) and a calculated fair value of \$1/share, the proposed standard would require that the company recognize \$61 of the expense in year 1, \$28 of the expense in year 2 and \$11 of the expense in year 3. Given that employee effort is delivered evenly across the vesting period and the value created for the company is evenly spread across the vesting period, why is the expense front end loaded? Looking at this another way, if a company has an employee contract with an individual for 3 years, shouldn’t that same logic apply to that salary expense? For example, for an employee with a 3-year contract to be paid \$33/year, this logic would lead one to recognize \$61 of salary expense in year 1, \$28 of expense in year 2 and \$11 of expense in year 3.

Lastly, I worry about the potential feedback loop effect of the proposed standard. Volatility is an input parameter in the fair value stock option expense calculation as proposed in the standard – the higher this volatility, the higher the calculated fair value of stock options and the higher the stock option expense, or more precisely, the higher the *volatility* of the stock option expense and thus company earnings. So, assuming that the introduction of the expensing of stock options will in itself drive greater earnings volatility, I think we can assume that stock prices will become more volatile as well. If stock prices become more volatile, by definition, that increases the volatility parameters used in the stock option fair value calculations, which, as we pointed out earlier, will drive even greater earnings and stock price volatility. I don’t see where the loop ends. Does volatility converge on some steady state value over time or does it slowly spiral upward indefinitely? Has sufficient analysis of this contingency been performed?

Summary

In general, it seems to me that the proposed standard will create additional meaningful cost to companies while providing dubious value to investors, creditors and other users of financial information.

As a partner in a venture capital company, the proposed standard would make it harder, not easier for me and my partners to assess company performance and evaluate investment opportunities, as well as place an unwanted cost and reporting burden on companies in our investment portfolio.

As an individual investor in the public markets, the proposed standard will make it harder, not easier for me to assess company performance and evaluate investment opportunities, as well as place an unwanted cost and reporting burden on the companies in which I have invested.

My suggestion is that we leave FASB 123 as it is today. If there are investors that want to see the impact of stock options on financial statements using fair-value accounting, they can do that through the footnotes.

Thank you for your time and consideration.

Sincerely,

John Dirvin
COO/Partner
Austin Ventures

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